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# Financing transactions

Partially updated December 2022

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# *About the Financing transactions guide*

PwC is pleased to offer our updated *Financing transactions* guide. This guide is intended to help our clients and other interested parties implement and apply the applicable accounting and reporting standards.

The accounting guidance for the issuance, modification, conversion, and repurchase of debt and equity securities has developed over many years into a complex set of rules. This guide provides a summary of the guidance relevant to the accounting for debt and equity instruments and serves as a roadmap to the applicable accounting literature. Portions of this guide assume that ASU 2020-06, *Debt-Debt with Conversion and Other Options (Subtopic 470-20)* and *Derivatives and Hedging-Contracts in an Entity's Own Equity (Subtopic 815-40)*, have been adopted. This guidance has significantly changed the accounting for convertible debt and has simplified the accounting for contracts in an entity's own equity. Each chapter discusses the relevant accounting literature and includes specific questions and examples to illustrate its application.

See PwC's *Financial statement presentation* guide for information on financial statement presentation and disclosure of the instruments and transactions discussed in this guide. See PwC's *Income taxes* guide for income tax accounting considerations related to debt and equity-linked financial instruments.

## *References to US GAAP*

Definitions, full paragraphs, and excerpts from the FASB's *Accounting Standards Codification* are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

## *References to other PwC guidance*

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Business combinations and noncontrolling interests (BCG)*
- *Consolidation (CG)*
- *Derivative instruments and hedging activities (DH)*
- *Fair value measurements (FV)*
- *Not-for-profit entities (NP)*
- *Carve-out financial statements (CO)*

- *Financial statement presentation (FSP)*
- *Income taxes (TX)*
- *Stock-based compensation (SC)*
- *Transfers and servicing of financial assets (TS)*

### *Summary of significant changes*

Following is a summary of the recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

### ***Revisions made in December 2022***

#### **Chapter 1, *Debt instruments***

- **FG 1.3** was updated related to treatments of costs associated with entering into a line of credit or revolving-debt arrangement.
- **FG 1.4.3** was updated to provide further information on the subsequent measurement of debt that settles through the issuance of a variable number of common shares with a then-current fair value equal to a fixed dollar amount.
- **FG 1.6.1** was updated with additional guidance on evaluating the net settlement criteria for certain share settled redemption features.

#### **Chapter 3, *Debt modification and extinguishment***

- Question **FG 3-1** in **FG 3.3** was added to address whether ASU 2022-02 is applicable to a borrower's accounting for troubled debt restructurings.
- Example **FG 3-5** in **FG 3.4.6** was amended to clarify how a reporting entity that has multiple modifications within a twelve-month period could apply the 10% cash flow test.

#### **Chapter 5, *Equity-linked instruments model***

- **FG 5.5.1.5** was added to discuss the guidance in ASC 480-10-15-7E for certain mandatorily redeemable noncontrolling interests.
- **FG 5.6.2.3** and **FG 5.6.2.3A** were added to discuss the accounting for greenshoes in equity offerings after adoption of ASU 2020-06 and before adoption of ASU 2020-06.
- Questions on the classification of convertible preferred equity certificates previously in **FG 5.6** and **FG 5.6A** were moved to **FG 7.3.1.2**.
- Guidance on disclosures on contracts in an entity's own equity after adoption of ASU 2020-06 was moved from **FG 5.8** to **FSP 5.7.1**.

## **Chapter 6, *Convertible debt after adoption of ASU 2020-06***

- Example **FG 6-2** in **FG 6.6** was added to demonstrate how to account for the extinguishment of a convertible debt instrument that was issued with a substantial premium.
- Discussion of the determination of whether a transaction would be considered an induced conversation or an extinguishment following adoption of ASU 2020-06 in **FG 6.8.2** was clarified.
- Guidance on EPS and disclosures of convertible debt instruments after adoption of ASU 2020-06 were moved from **FG 6.10** and **FG 6.11**, respectively, to **FSP 7.5.6** and **FSP 12.12.6**.

## **Chapter 7, *Preferred stock***

- Question **FG 7-7** on the classification of convertible preferred equity certificates was moved from **FG 5** to **FG 7.3.1.2**.
- Question **FG 7-9** in **FG 7.3.4** was added to address mezzanine equity presentation for redeemable preferred stock instruments where there is a cap on the amount of preferred stock that the issuer can be forced to redeem.
- Questions **FG 7-11** and **FG 7-12** in **FG 7.3.4.3** were added to address the appropriate presentation of callable preferred stock when the preferred shareholders control the issuer's board of directors.
- Question **FG 7-16** in **FG 7.4.3.2** was added to discuss the subsequent measurement of a mezzanine equity classified preferred stock instrument that contains a separated embedded derivative.
- Example **FG 7-4** in **FG 7.4.3.2** was added to illustrate how to subsequently measure a mezzanine equity classified preferred stock instrument that is redeemable based on an index.
- Guidance on disclosures of preferred stock instruments after adoption of ASU 2020-06 was moved from **FG 7.11** to **FSP 5.6.4.2**.

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***Chapter 1:***  
***Debt instruments—updated***  
***December 2022***



## 1.1 Overview of debt instruments

This chapter discusses the accounting considerations for various types of debt instruments including the following topics.

- Term debt
- Lines of credit and revolving-debt arrangements
- Debt accounted for at fair value based on the guidance in ASC 825, *Financial Instruments*
- Amortization of deferred debt issuance costs, debt discount and premium
- Put options, call options, and other embedded features in debt instruments

See FG 3 for information on the accounting for debt modifications and extinguishments, and FG 6 (post adoption of ASU 2020-06) or FG 6A (pre adoption of ASU 2020-06) for information on the accounting for convertible debt instruments. See FSP 12 for information on the financial statement presentation and disclosure of debt instruments, including balance sheet classification.

### ***New guidance***

In August 2020, the FASB issued 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)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the “own stock” scope exception (see FG 5) and certain aspects of the EPS guidance.

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity’s most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

Guidance in this chapter has been updated to reflect the new ASU and impacted sections are denoted with “after adoption of ASU 2020-06” and “before adoption of ASU 2020-06.”

## 1.2 Term debt

Term debt has a specified term and coupon. The coupon may be fixed or based on a variable interest rate. Upon issuance, the issuer recognizes a liability equal to the proceeds (e.g., cash) received, less any allocation of proceeds to other instruments issued with the debt, other elements of the transaction, or

features within the debt instrument itself. The proceeds generally approximate the present value of interest and principal payments of the debt. Debt should be recognized on the date the proceeds are received (settlement date) rather than on the trade date.

### **1.2.1 Debt discount and premium—after adoption of ASU 2020-06**

When the proceeds received are not the same as the amount due at maturity, a debt instrument has been issued at a discount or premium.

#### **Definitions from ASC Master Glossary**

**Discount:** The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity.

**Premium:** The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity.

A debt discount may reflect fees paid by a reporting entity to a lender as part of a debt issuance or the issuance of debt at a below market coupon. When a reporting entity issues debt at a discount, it receives less proceeds than it will repay; thus, the reporting entity is paying a higher effective interest rate than the coupon specified in the debt agreement (i.e., it is paying the coupon and the original issue discount). A debt discount is a reduction of the carrying amount of a debt liability.

A debt discount can also be created by the following:

- The separation of an embedded derivative (e.g., put option) from a debt instrument. See FG 1.6 for information on embedded features in debt instruments
- The allocation of proceeds to warrants or equity securities issued in connection with a debt instrument. See FG 8.4.1 for information on debt issued with warrants
- The adjustment to the carrying amount of a debt instrument as a result of a fair value hedging relationship. See DH 5.4 for information on fair value hedges

A debt premium typically reflects the issuance of debt at an above market coupon. A debt premium can also be created through an adjustment to the carrying amount of a debt instrument as a result of a fair value hedging relationship or through the separation of an embedded derivative that is an asset (e.g., a purchased option).

As discussed in ASC 835-30-45-1A, a debt discount or premium should be recorded as an adjustment to the carrying amount of the related liability.

### **1.2.1A Debt discount and premium—before adoption of ASU 2020-06**

When the proceeds received are not the same as the amount due at maturity, a debt instrument has been issued at a discount or premium.

### Definitions from ASC Master Glossary

**Discount:** The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity.

**Premium:** The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity.

A debt discount may reflect fees paid by a reporting entity to a lender as part of a debt issuance or the issuance of debt at a below market coupon. When a reporting entity issues debt at a discount, it receives less proceeds than it will repay; thus, the reporting entity is paying a higher effective interest rate than the coupon specified in the debt agreement (i.e., it is paying the coupon and the original issue discount). A debt discount is a reduction of the carrying amount of a debt liability.

A debt discount can also be created by the following:

- The separation of an embedded derivative (e.g., put option) from a debt instrument. See FG 1.6 for information on embedded components in debt instruments
- The separation of a beneficial conversion feature or cash conversion option in a convertible debt instrument. See FG 6.7A for information on beneficial conversion features and FG 6.6A for information on convertible instruments within the scope of the cash conversion guidance
- The allocation of proceeds to warrants or equity securities issued in connection with a debt instrument. See FG 8.4.1 for information on debt issued with warrants
- The adjustment to the carrying amount of a debt instrument as a result of a fair value hedging relationship. See DH 5.4 for information on fair value hedges

A debt premium typically reflects the issuance of debt at an above market coupon. A debt premium can also be created through an adjustment to the carrying amount of a debt instrument as a result of a fair value hedging relationship or through the separation of an embedded derivative that is an asset (e.g., a purchased option).

As discussed in ASC 835-30-45-1A, a debt discount or premium should be recorded as an adjustment to the carrying amount of the related liability.

### 1.2.2 *Debt issuance costs*

Issuance costs are specific incremental costs, other than those paid to the lender, which are incurred by a borrower and directly attributable to issuing a debt instrument. Issuance costs include the following.

- Document preparation costs
- Commissions, fees and expenses of investment bankers, underwriters, or others
- Original issue taxes
- Registration and listing fees

- Accounting and legal fees
- Other external, incremental expenses paid to advisors that clearly pertain to the financing

Costs that do not qualify as issuance costs include bonuses paid to employees (even if attributed to the employees' involvement in the financing), employee performance stock options with long-term debt issuance milestones, and premiums for Director's and Officers' insurance policies (even if mandated by the underwriters).

Like debt premiums and discounts, debt issuance costs should be reported as an adjustment to the carrying amount of the related liability as discussed in ASC 835-30-45-1A.

#### **Excerpt from ASC 835-30-45-1A**

Similarly, debt issuance costs related to a note shall be reported in the balance sheet as a direct deduction from the face amount of that note. The discount, premium, or debt issuance costs shall not be classified as a deferred charge or deferred credit.

See FG 1.2.3 for information on amortization of debt issuance costs.

#### **Question FG 1-1**

A reporting entity pays a non-refundable commitment fee in connection with an underwriter's agreement to provide bridge financing in the event the reporting entity's debt offering is delayed or cannot be executed.

Should the commitment fee be included as a debt issuance cost of the debt offering?

#### ***PwC response***

No. ASC 340-10-S99-2 provides guidance on the accounting for costs related to a bridge financing.

The commitment fee should be deferred and amortized over the commitment period. Any unamortized amount remaining upon the execution of the debt offering should be written off as the commitment has expired unused. Even if the reporting entity pays fees to the same underwriter in connection with the debt offering, ASC 340-10-S99-2 clarifies that the commitment fee and the underwriting fees should be distinguished for accounting purposes. We believe this guidance should also be applied by non-public companies.

#### **Question FG 1-2**

A reporting entity engages an investment bank to structure a loan syndication on a best efforts basis. Although the debt is not expected to be issued for several months, the bank is entitled to fees during the intervening period, based on milestones reached.

Presuming the fees incurred qualify as debt issuance costs, should the reporting entity defer these fees prior to the debt issuance?

***PwC response***

We believe the guidance in ASC 340-10-S99-1 should be applied by analogy. If the reporting entity concludes that the likelihood of the syndicated loan being placed is probable, the fees should be accounted for as a deferred asset. If, on the other hand, the likelihood of the loan syndication being placed is considered remote, it may be more appropriate to expense the fees as they are incurred.

If the loan syndication's prospects fall somewhere between probable and remote, judgment should be applied to determine which treatment is more appropriate. Some factors to consider in determining the appropriate accounting treatment include whether payment milestones have been and are expected to be achieved and the reporting entity's history with respect to previous debt issuances.

**1.2.3 Amortization of debt issuance costs, discounts, and premiums**

ASC 835-30-35-2 provides guidance on the amortization of a debt discount or premium.

**ASC 835-30-35-2**

With respect to a note for which the imputation of interest is required, the difference between the present value and the face amount shall be treated as discount or premium and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the interest method.

Although ASC 835-30-35-2 requires the use of the interest method for the amortization of debt discount and premium, ASC 835-30-35-4 indicates that other methods of amortization, including the straight-line method, may be used if the results obtained are not materially different from those that would result from use of the interest method. These differences should be analyzed each period for materiality.

With regard to the length of the amortization period, it is not clear whether ASC 835-30-35-2 is referring to the contractual life of an instrument or some shorter period. Although it is commonly understood to mean the contractual life, depending on a debt instrument's terms and features, it may be appropriate to amortize any discount or premium over a shorter period.

We believe a shorter amortization period, such as the period from the issuance date to the date a put is first exercisable, is appropriate when a lender can demand repayment in circumstances outside of a reporting entity's control. Using a shorter amortization period ensures that there will be no extinguishment gain or loss in the event a lender exercises its put option prior to the contractual maturity of the debt. However, amortization over the contractual life of a debt instrument is also permitted.

In most cases, debt issuance costs are amortized over the same period as debt discount or premium. This approach is supported by guidance in ASC 470, *Debt*, and other accounting literature. When a debt instrument is puttable by a lender at a price less than the par value, it may be appropriate to use a different amortization period for debt issuance costs than the debt discount and premium. See FG 1.2.3.1 for further information. When there is more than one amortization period that is acceptable, a reporting entity should elect a method, apply it consistently, and disclose it.

As discussed in ASC 835-30-35-5, the amount chargeable to interest expense pursuant to ASC 835-30 (e.g., amortization of debt discount or premium) is eligible for inclusion in the amount of interest cost capitalized in accordance with ASC 835-20.

If a debt instrument is accounted for at fair value under ASC 825, the issuance costs should be immediately expensed. If the debt was issued with other instruments (e.g., warrants) that are also measured at fair value, there may be occasions when the proceeds allocated to the debt instrument accounted for at fair value differ from the fair value of the debt instrument at issuance. To the extent the allocated proceeds received differ from the fair value of the debt instrument, the difference should be recorded in the income statement. See FG 1.5 for information on accounting for debt at fair value.

### **1.2.3.1 *Amortization period for debt puttable at accreted value***

In general, a discount or premium should be amortized using the interest method over the same period used to amortize debt issuance costs. However, when debt is puttable at accreted value (the amount equal to the current basis of the debt, based on the discount or premium at issuance, less the amount of the discount or premium amortized to date based on an effective yield, but excluding the impact of debt issuance costs), it may be more appropriate to amortize a discount or premium over the contractual life of the debt because the reporting entity will “retain” the unamortized portion of the discount or premium if the lender puts the debt prior to maturity. The same is not true for debt issuance costs, since these amounts are paid to third parties and are “lost” when the debt is redeemed at any price.

When a debt instrument is puttable at accreted value, we believe the discount or premium should be amortized over the contractual life of the debt such that the carrying amount of the debt is equal to the put price on the date the put is first exercisable. The discount or premium should continue to be amortized such that the carrying amount of the debt is equal to the put price on each subsequent put date as well. Because the carrying amount equals the price at which the debt can be put, there will be no gain or loss on extinguishment if the lender exercises its put option prior to maturity.

Debt issuance costs can either be amortized over the period from the issuance date to the date the put is first exercisable, or over the contractual life along with the debt discount or premium. A reporting entity should elect one of these amortization methods and apply it consistently. When the same period is used to amortize debt issuance costs and debt discount or premium (e.g., the contractual life), it results in one constant effective rate of interest for the debt instrument, consistent with the interest method. Although issuance costs will remain on the balance sheet after the date the lender can exercise its put option and demand repayment, the same is true any time a reporting entity amortizes issuance costs over the contractual life when the instrument is puttable at an earlier date.

### **1.2.3.2 *Amortization period for callable debt***

Term debt that a reporting entity can call prior to its maturity date is similar to short-term debt that can be extended. Increasing rate debt is contractually short term with an embedded term-extending option that allows a reporting entity to make it long term; callable debt is contractually long term with an embedded call option that allows a reporting entity to make it short term. Therefore, we believe a reporting entity may elect to amortize debt issuance costs, discounts and premiums related to callable debt over either the contractual life of the debt instrument (consistent with term debt) or the estimated life of the debt instrument (by analogy to the guidance for increasing rate debt in ASC 470-10-35-2). A reporting entity should elect one of these methods and apply it consistently. See FG 1.4.1 for information on the accounting for increasing rate debt.

When the exercisability of a call option is subject to a contingency, the reporting entity should consider the effect of the contingency on the likelihood the reporting entity can exercise its call option. In circumstances where the contingency is remote, the estimated life of the debt instrument and its contractual maturity should be the same.

If a reporting entity elects the estimated life of the debt instrument as the amortization period, the life used should reflect the best estimate considering the reporting entity's plans, ability and intent to service the debt as described in ASC 470-10-35-2, as well as economic factors affecting the desirability of calling the debt. There may be circumstances in which the economic factors affecting the desirability to exercise the call option indicate that the best estimate of the debt instrument's life is its contractual life.

We believe that an accounting policy election should be made as to whether estimates will be updated for a specific debt instrument, and that policy should be applied consistently across similar instruments. A reporting entity may decide that the estimated life is established at the issuance date and will not be updated.

### **1.2.3.3 *Effect of covenant violations on amortization period***

Many debt agreements contain covenants that the reporting entity must adhere to throughout the life of the agreement. Covenants are negotiated between a reporting entity and its lenders and may vary from agreement to agreement. Financial ratio covenants, which require the reporting entity to maintain various financial ratios, are included in nearly every debt agreement. A breach of a covenant triggers an event of default which may allow the lender to demand repayment (i.e., it becomes puttable).

When a covenant violation causes long-term debt to become puttable, the debt and related debt discount, premium, or issuance costs may need to be reclassified as current liabilities; however, we do not believe debt issuance costs, discounts, or premiums should be automatically amortized in full upon the reclassification of a long-term liability to a current liability.

ASC 470-10-45-7 indicates that the classification of the debt (and related contra accounts) does not have to be the same as the time frame used to amortize debt issuance costs, discount, and premium. A reporting entity should evaluate its specific facts and circumstances, including the following points, to determine whether it should amortize its debt issuance costs, discounts, or premiums in full.

- The nature and existence of active negotiations between the lender and the reporting entity to secure a waiver, or restructure the debt
- The financial condition of the reporting entity, and the likelihood that the lender will demand repayment rather than grant a waiver
- Its history of obtaining prior waivers, if any, from the lenders
- Execution of a written forbearance agreement and whether, during the forbearance period, the parties have agreed to negotiate to restructure the debt

If the preponderance of the evidence at the financial statement issuance date leads a reporting entity to conclude that there is a reasonable likelihood that it will be able to successfully negotiate a waiver

with the lender, then amortization of debt issuance costs, discounts, and premiums should continue as before the violation, with adequate disclosure of the circumstances.

If a lender waives a covenant violation for no consideration (either explicit or implicit), no accounting is required under ASC 470-50-40 because there is no change in cash flows. A payment (of cash or other instruments) made to a lender to effect a waiver of a covenant violation is considered a modification of the terms of the debt instrument. When such a payment is made, the reporting entity should analyze the modification using the debt modification guidance discussed in FG 3.4.

### Question FG 1-3

A reporting entity violates a covenant in its puttable debt instrument. The reporting entity restructures its debt agreement and obtains a debt covenant waiver. As a result of the waiver, the debt is classified as noncurrent in its period end financial statements. As part of the restructuring, the date the put option is first exercisable is accelerated; however, the contractual term remains the same as the original debt instrument.

Does the covenant violation or debt modification have an effect on the reporting entity's amortization of debt issuance costs, discounts, or premiums?

#### *PwC response*

Maybe. The reporting entity should first determine whether the restructuring qualifies as a troubled debt restructuring (refer to FG 3.3). If the reporting entity determines this is not a troubled debt restructuring, it should apply the guidance in ASC 470-50-40-10 to determine whether the changes to the instrument should be accounted for as a modification or extinguishment. See FG 3.4 for information on accounting for a modification of a term loan or debt security. If the debt instrument is modified and the transaction is accounted for as a modification, the reporting entity should continue to account for the debt issuance costs, discounts or premiums based on its accounting policy election as of the original issue date.

If the reporting entity has elected an amortization period from the issuance date to the date the put is first exercisable, then, as of the modification date, any unamortized debt issuance costs, discounts, or premiums should be amortized to the new put date. If the reporting entity has elected an amortization period over the contractual life of the debt instrument, it should continue this policy.

If the modification is accounted for as an extinguishment, then any unamortized debt issuance costs, discounts, or premiums should be expensed as part of the extinguishment gain or loss.

If the reporting entity had not obtained a waiver as of the financial statement issuance date, and the preponderance of the evidence lead to a conclusion that it would not be able to negotiate a waiver, any debt issuance costs, discounts, or premiums would have been expensed as of the date that the debt became puttable (i.e., the covenant violation date), because the debt was, and would continue to be, demand debt notwithstanding any restructuring.

#### **1.2.4** *Delayed draw debt*

A reporting entity may enter into an agreement with a lender that allows the reporting entity to delay the funding of its debt, provided it is drawn within a specified time period (i.e., the reporting entity gets to choose the date that the debt funds within a specified time frame). This differs from a line of credit or revolving-debt agreement because once the debt is funded, it cannot be repaid and then



borrowed again. Many agreements do not require that the reporting entity draw the full commitment amount at once; instead, a reporting entity can borrow a portion of the total debt commitment at different points in time.

When a reporting entity enters into a delayed draw debt agreement, it pays a commitment fee to the lender in exchange for access to capital over the contractual term. That is, the fees are paid whether or not the funds are ever drawn down. As such, we believe these costs meet the definition of an asset and should be recorded as such on the balance sheet. We believe that the subsequent accounting for deferred costs is based on the facts and circumstances. For instance, if a reporting entity is near certain that it will draw down/borrow the debt, the commitment fee is economically compensation for the borrowing, and we believe it would be appropriate for the commitment fee to remain as an asset on the balance sheet until the debt is drawn. Once the debt is drawn, the reporting entity should record the debt on its balance sheet, derecognize the commitment fee asset, and record the commitment fee as a component of the debt's amortized cost basis. The adjustment to the amortized cost basis will be amortized over the term of the debt as component of the debt's effective yield. If a reporting entity borrows a portion of the debt, only a proportionate amount of the commitment fee asset should be recognized as an adjustment to the amortized cost basis of the debt drawn.

In other instances, the reporting entity may have entered into the delayed draw simply to have access to the funds but without any current intention to draw down the debt. In this scenario, we believe it would be appropriate for the reporting entity to amortize the commitment fee on a straight-line basis over the access period. If it becomes probable that the debt (or a portion of the debt) will not be drawn during the access period, any remaining deferred costs (or portion of the costs) may be expensed.

See FG 3.4.13 for discussion of debt modification or exchange on delayed draw term loans.

### **1.3 *Lines of credit and revolving-debt arrangements***

A line of credit is an extension of credit to a borrower that can be accessed or “drawn down” at any time at the reporting entity's discretion. Borrowings under a line of credit may be used, repaid, and reborrowed in different amounts and at different intervals. A reporting entity pays the lender a commitment fee in exchange for the lender's commitment to lend to the reporting entity under the line of credit or revolving-debt arrangement for the term of the arrangement.

Costs associated with entering into a revolving line of credit or revolving-debt arrangement are costs incurred in exchange for access to capital. That is, the fees are paid regardless of whether the funds are ever drawn down. As such, we believe these costs meet the definition of an asset and should be recorded as such on the balance sheet (as opposed to the contra liability presentation used for debt issuance costs) and amortized on a straight-line basis over the contractual term of the arrangement (i.e., the access period) regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. This accounting is consistent with the view expressed by the SEC in ASC 835-30-S45-1.

Other views may be acceptable. For instance, in the limited circumstances when a reporting entity draws down on a line of credit and does not intend to repay the borrowing until the contractual maturity of the arrangement (i.e., the borrowing is treated like a term loan), we believe the portion of the costs related to that draw down could be presented as a direct deduction from the carrying value of the debt when drawn. Under this approach, the reporting entity should amortize the costs for the portion associated with the draw down using the effective interest method (as is done for a term loan).

## 1.4 Other types of debt

There are many other types of debt instruments. In the following sections we discuss the accounting considerations for some of the more common forms of structured debt instruments.

### 1.4.1 Increasing rate debt

ASC 470-10-35-1 and ASC 470-10-35-2 provide a description of and guidance on increasing rate debt.

#### ASC 470-10-35-1

A debt instrument may have a maturity date that can be extended at the option of the borrower at each maturity date until final maturity. In such cases, the interest rate on the note increases a specified amount each time the note is renewed. For guidance on accounting for interest, see Subtopic 835-30.

#### ASC 470-10-35-2

The borrower's periodic interest cost shall be determined using the interest method based on the estimated outstanding term of the debt. In estimating the term of the debt, the borrower shall consider its plans, ability, and intent to service the debt. Debt issue costs shall be amortized over the same period used in the interest cost determination. The term-extending provisions of the debt instrument should be analyzed to determine whether those provisions constitute an embedded derivative that warrants separate accounting as a derivative under Subtopic 815-10.

The amortization period for debt issuance costs, discounts, and premiums associated with increasing rate debt should be the estimated life of the instrument.

As discussed in ASC 470-10-45-8, if increasing rate debt is repaid at par prior to its estimated maturity, the reversal of any excess interest accrued should be recognized as an adjustment of interest expense and not a part of the gain or loss on extinguishment.

ASC 815-15-25-44 provides guidance on whether a term-extending option should be separated and accounted for as a derivative. See FG 1.6.1.3 for information on term-extending options.

### 1.4.2 Special assessments and tax increment financing entities

A reporting entity that intends to develop real estate it owns or leases may form a tax increment financing entity (TIFE) to finance the construction of road, water, and other utility infrastructure for a specific project. The TIFE issues debt that is repaid through future user fees or tax assessments. ASC 970-470, *Real Estate* provides guidance on the accounting for a TIFE.

#### ASC 970-470-25-1

If the special assessment or the assessment to be levied by the tax increment financing entity on each individual property owner is a fixed or determinable amount for a fixed or determinable period, there is a presumption that an obligation shall be recognized by the property owner. Further, with respect to tax increment financing entities, factors such as the following indicate that an entity may be contingently liable for tax increment financing entity debt, and recognition of an obligation shall be evaluated under Topic 450:

- a. The entity must satisfy any shortfall in annual debt service obligations.
- b. There is a pledge of entity assets.
- c. The entity provides a letter of credit in support of some or all of the tax increment financing entity debt or provides other credit enhancements.

#### **ASC 970-470-25-2**

If the entity is constructing facilities for its own use or operation, the presence of any of the factors in the preceding paragraph creates a presumption that the tax increment financing entity debt must be recognized as an obligation of the entity.

A reporting entity should also determine whether a TIFE is a variable interest entity and whether it qualifies for a scope exception under ASC 810-10-15-17. See CG 1.3.1 for additional information on consolidation of variable interest entities.

### **1.4.3 *Debt payable in common stock***

Debt that requires an issuing entity to make fixed (dollar value) payments of principal or interest in equity shares should be classified as a liability pursuant to the guidance in ASC 480-10-25-14 provided that it is an obligation to issue a variable number of shares and, at inception, the monetary value of the obligation is based solely or predominantly on a fixed dollar amount.

ASC 480-10-35-5 indicates that financial instruments other than those discussed in ASC 480-10-35-3 through 35-4A shall be subsequently measured at fair value, unless another Subtopic specifies another measurement model. Debt instruments that settle through the issuance of a variable number of shares with a then-current fair value equal to a fixed dollar amount are the economic equivalent of cash settled debt. As such, we believe these instruments are subject to ASC 470 and ASC 835 and therefore, we do not believe these instruments are required to be subsequently measured at fair value with changes in fair value recorded in earnings, despite being within the scope of ASC 480-10-25-14. Rather, subsequent measurement in a manner similar to term debt as discussed in FG 1.2 is acceptable. See FG 5.5 for information on the application of ASC 480.

### **1.4.4 *Multi-modal public debt***

Debt issued with a “multi-modal” option provides a reporting entity with a contractual right to call the debt to change the type of interest paid. A common example of multi-modal debt is a bond that provides a reporting entity with the ability to change the interest paid from an auction-based interest rate to a stated rate; the stated rate may be based on a variable interest rate or a fixed interest rate. To change the type of interest paid a reporting entity will typically perform the following steps.

- Issue a “Notice of Interest Rate Conversion” to inform investors of the interest rate conversion (i.e., exercise of the reporting entity’s call option)
- Investors legally surrender the bonds to a tender agent
- Simultaneously, new bonds bearing the new interest rate are issued (or sold) to investors; the investors may include new investors as well as investors that held the called bonds

- The proceeds received from the new bonds are used to pay former investors a pre-determined amount specified in the bond indenture (e.g., par value). If the proceeds from the new issue are insufficient, or if the bond remarketing fails, the reporting entity funds the shortfall

Because, in most cases, an interest rate conversion involves a tender of the old bonds and marketing of new bonds, it is similar to a traditional bond refunding. When existing investors have their debt paid off, the issuer should account for the refunding as a debt extinguishment. When existing investors continue to hold the new bonds, the issuer is not subject to the modification guidance in ASC 470-50-40-10 because the exchange of the old bonds for new bonds is considered an exercise of a provision in the original debt agreement. The effective interest rate of the bonds is adjusted prospectively. See FG 3.4 for information on the accounting for an exchange of a term loan or debt security.

#### **1.4.5 Sales of future revenues**

As discussed in ASC 470-10-25-1, a sale of future revenue typically involves a reporting entity receiving cash from an investor and agreeing to pay to the investor, for a defined period, a specified percentage or amount of the revenue or of a measure of income (e.g., gross margin, operating income, pretax income) of a particular product line, business segment, trademark, patent, or contractual right. Typically, immediate income recognition is not appropriate.

The cash flows to be provided to the investor in a sale of future revenue will vary based on the reporting entity's future revenues or other measure of income. Generally, these features do not require bifurcation because a separate contract with the same terms would be excluded from the scope of ASC 815 based on the exception in ASC 815-10-15-59(d). This scope exception applies when the underlying on which settlement is based involves a specified volume of sales or service revenues of one of the parties to the contract. Refer to DH 3.2.7.3 for additional discussion on this scope exception.

ASC 470-10-25-2 provides a number of factors to be considered in determining whether the proceeds received from the investor should be classified as debt or deferred income.

#### **ASC 470-10-25-2**

While the classification of the proceeds from the investor as debt or deferred income depends on the specific facts and circumstances of the transaction, the presence of any one of the following factors independently creates a rebuttable presumption that classification of the proceeds as debt is appropriate:

- a. The transaction does not purport to be a sale (that is, the form of the transaction is debt).
- b. The entity has significant continuing involvement in the generation of the cash flows due the investor (for example, active involvement in the generation of the operating revenues of a product line, subsidiary, or business segment).
- c. The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity.
- d. The investor's rate of return is implicitly or explicitly limited by the terms of the transaction.
- e. Variations in the entity's revenue or income underlying the transaction have only a trifling impact on the investor's rate of return.
- f. The investor has any recourse to the entity relating to the payments due the investor.

In many cases, the reporting entity has significant continuing involvement in the generation of the cash flows due to the investor. The presence of this factor creates a rebuttable presumption that the proceeds should be classified as debt.

As described in ASC 470-10-35-3, in situations when debt classification is appropriate, the reporting entity must determine an effective interest rate and amortize the debt under the interest method. The effective interest rate should be determined based on the proceeds received and projections of the amounts and timing of the future cash outflows.

A reporting entity should revisit its estimate of future cash outflows each reporting period. When the amount and timing of the estimated future cash flows change, one of the following three methods should be applied:

- **Prospective approach:** A new effective interest rate is computed based on the current carrying value of the debt and the revised estimated remaining cash flows. Changes in cash flows from previous estimates are included in future interest expense on a prospective basis.
- **Catch-up approach:** The carrying value of the debt is adjusted to the present value of the revised estimated cash flows discounted at the original effective interest rate. Using this approach, the impact of the change in cash flows is recorded in the current period.
- **Retrospective approach:** A new effective interest rate is computed based on the original proceeds received, actual cash flows to date, and the revised estimate of remaining cash flows. The new effective interest rate is then used to adjust the carrying value of the debt to the present value of the revised estimated cash flows, discounted at the new effective interest rate. Using this approach, the impact of the change in cash flows is recorded in the current and future periods.

While a current period adjustment is recorded under both the catch-up and retrospective approaches, the key distinction relates to the effective interest rate. In a catch-up approach, cash flows are updated to reflect current estimates, but the rate used to discount those cash flows remains the original effective interest rate. Under the retrospective approach, the effective interest rate is changed to reflect the actual cash flows paid to date and the revised estimate of future cash flows.

## **1.5 Accounting for debt at fair value—after adoption of ASU 2020-06**

A reporting entity may elect to measure certain of its debt instruments at fair value, generally on an instrument-by-instrument basis, under the guidance in ASC 825. Electing to carry an instrument at fair value is commonly referred to as the fair value option. Generally, a reporting entity can only elect the fair value option on the date the debt instrument is initially recognized. Once made, the election is irrevocable unless a remeasurement event occurs.

ASC 825-10-15-5(f) provides guidance on the application of the fair value option to certain convertible debt instruments.

**Excerpt from ASC 825-10-15-5**

No entity may elect the fair value option for any of the following financial assets and financial liabilities:

...

- f. Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders' equity (including temporary equity)

Convertible debt instruments issued with a substantial premium are not eligible for the fair value option under ASC 825 based on this guidance. The fair value option may be elected for all other convertible debt instruments, although reporting entities do not frequently elect to do so.

FV 5 discusses the principal reporting and presentation implications for items for which the fair value option is elected. With respect to debt, these implications include the following:

- The initial carrying amount of the debt is its fair value, determined in accordance with ASC 820, *Fair Value Measurement*, which may differ from the proceeds received upon issuance
- Issuance costs associated with the debt may not be deferred
- A reporting entity should make an accounting policy election when reporting interest expense attributable to a debt instrument carried at fair value. See FSP 20.6.1.2 for information on the presentation of interest expense (and other changes in fair value) for debt instruments carried at fair value.

See FV 6 for information on valuation considerations relevant to debt.

## **1.5A Accounting for debt at fair value—before adoption of ASU 2020-06**

A reporting entity may elect to measure certain of its debt instruments at fair value, generally on an instrument-by-instrument basis, under the guidance in ASC 825. Electing to carry an instrument at fair value is commonly referred to as the fair value option. Generally, a reporting entity can only elect the fair value option on the date the debt instrument is initially recognized. Once made, the election is irrevocable unless a remeasurement event occurs.

ASC 825-10-15-5(f) provides guidance on the application of the fair value option to certain convertible debt instruments.

**Excerpt from ASC 825-10-15-5**

No entity may elect the fair value option for any of the following financial assets and financial liabilities:

...

- f. Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders' equity (including temporary equity) (for example, a convertible debt instrument within the scope of the Cash Conversion Subsections of Subtopic 470-20 or a convertible debt security with a noncontingent beneficial conversion feature).

Convertible debt instruments that are bifurcated into a debt and an equity component based on the guidance in ASC 470-20, such as debt with a cash conversion feature, beneficial conversion feature, or substantial premium, are not eligible for the fair value option under ASC 825 based on this guidance. The fair value option may be elected for all other convertible debt instruments, although reporting entities do not frequently elect to do so.

FV 5 discusses the principal reporting and presentation implications for items for which the fair value option is elected. With respect to debt, these implications include the following:

- The initial carrying amount of the debt is its fair value, determined in accordance with ASC 820, *Fair Value Measurement*, which may differ from the proceeds received upon issuance.
- Issuance costs associated with the debt may not be deferred.
- A reporting entity should make an accounting policy election when reporting interest expense attributable to a debt instrument carried at fair value. See FSP 20.6.1.2 for information on the presentation of interest expense (and other changes in fair value) for debt instruments carried at fair value.

See FV 6 for information on valuation considerations relevant to debt.

## 1.6 *Embedded components within debt instruments*

Many debt instruments include embedded components. A borrower should evaluate these embedded components to determine whether they are embedded derivatives within the scope of ASC 815 that should be separately carried at fair value.

ASC 815-15-25-1 provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative.

### **ASC 815-15-25-1**

An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

The most common features embedded in a debt instrument are put and call options. A put option allows a lender to demand repayment, and a call option allows a borrower to repay debt before its maturity date.

### **1.6.1 Embedded put and call options**

Provided a host debt instrument is not accounted for at fair value with changes in fair value recorded in net income, the first step in assessing whether an embedded put or call option should be separately accounted for as a derivative is to determine whether the embedded option would be accounted for as a derivative under the guidance in ASC 815 if it were a freestanding instrument. To do this, a reporting entity should assess whether the embedded put or call option (1) meets the definition of a derivative or (2) qualifies for a scope exception to derivative accounting in ASC 815. Most put and call options embedded in a debt instrument do meet the definition of a derivative and do not qualify for a scope exception to derivative accounting in ASC 815. A put or call option embedded in a host debt instrument meets the net settlement criterion in ASC 815-10-15-83(c) because its settlement results in the delivery of an instrument to its issuer. Thus, the extinguishment of debt as part of the exercise of a call or put option is not considered to be the delivery of an asset to the debtor and the creditor does not receive an asset associated with the underlying. This is true even if the issuer has the option or is required to settle the debt in a variable number of shares with a fair value equal to the strike price, rather than cash. This is because even if settled in a variable number of shares, neither party is required to deliver an asset associated with the underlying of the embedded option. In these situations, changes in the fair value of the shares delivered do not impact the value of the debt and, as such, equity prices are not considered to be an underlying. These put and call options should be evaluated to determine whether they are clearly and closely related to their host debt instrument.

See DH 2 for a discussion of the definition of a derivative and DH 3 for a discussion of scope exceptions to ASC 815.

#### **1.6.1.1 Puts and calls—clearly and closely related analysis**

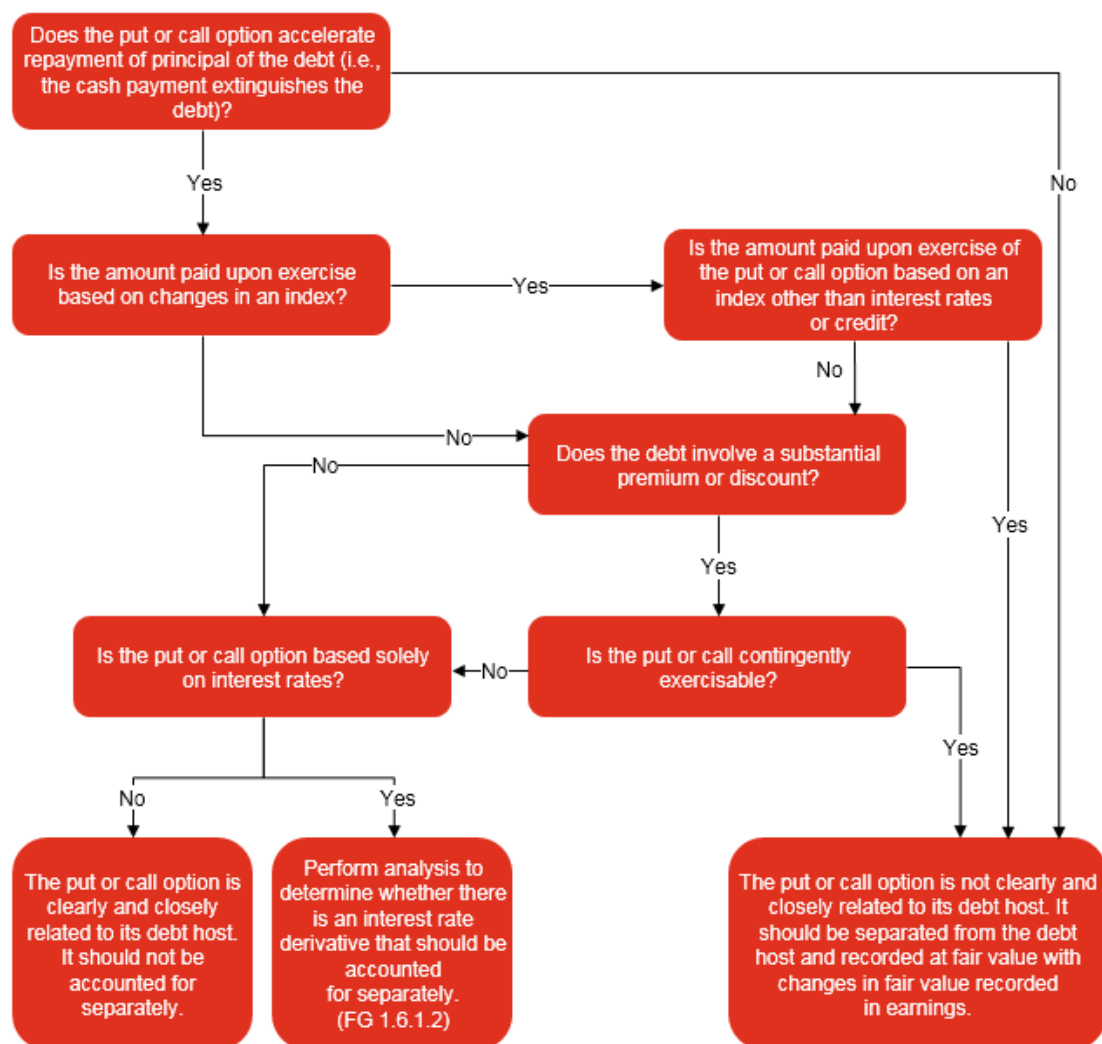
Generally, a put or call option is considered clearly and closely related to its debt host unless it is leveraged (i.e., it creates more interest rate and/or credit risk than is inherent in the host instrument). For example, debt issued at par value that is puttable at two times the par value upon the occurrence of a specified event may have an embedded component that is not clearly and closely related to its debt host instrument.

Figure FG 1-1 illustrates the analysis to determine whether a put or call option is clearly and closely related to its debt host instrument. If the put or call option is not considered clearly and closely related to its host debt instrument based on this analysis, it should be separately accounted for as a derivative under the guidance in ASC 815.



**Figure FG 1-1**

Determining whether an embedded put or call option is clearly and closely related to its host debt instrument



See Example FG 1-1 for an illustration of the different analyses for a put option and a term extending option. The example is written from the perspective of an investor; however, an issuer would follow the same guidance.

### EXAMPLE FG 1-1

#### Analysis of put options and options to extend debt

Investor Corp purchases two bonds: Bond A and Bond B. Both bonds are issued by the same issuer at par and have a coupon rate of 6%.

Bond A has a stated maturity of ten years, but the investor can put it back to the issuer at par after three years.

Bond B has a stated maturity of three years, but after three years the investor can extend the maturity to ten years (i.e., seven more years) at the same initial interest rate (i.e., neither the interest rate, nor the credit spread, are reset to the then-current market interest rate).

Assume the following scenarios exist at the end of three years:

**Scenario 1:** The issuer's interest rate for seven-year debt is 8%. The investor will put Bond A back to the issuer and reinvest the par amount of the bond at 8%. The investor will not extend the maturity of Bond B and instead will reinvest the principal at 8%.

**Scenario 2:** The issuer's interest rate for seven-year debt is 4%. The investor will not put Bond A back to the issuer and instead will continue to receive 6% for the next seven years. The investor will extend the term of Bond B and continue to receive 6% for the next seven years.

How should the embedded derivatives in Bond A and Bond B be analyzed?

### *Analysis*

Although in both scenarios the issuer and Investor Corp are in the same economic position with respect to Bond A and Bond B, ASC 815 may require that they be treated differently.

The put option in Bond A would generally not have to be separated because calls and puts in debt hosts are generally clearly and closely related to the host contract, unless they meet the conditions in ASC 815-15-25-42 or ASC 815-15-25-26.

On the other hand, ASC 815-15-25-44 indicates that the term-extending option in Bond B may not be clearly and closely related to its debt host because its interest rate and credit spread are not reset to the then-current market interest rate when the option is exercised. However, only term-extending options in debt hosts that cause an investor to potentially not recover substantially all of its recorded investment (i.e., lose principal) would be considered not clearly and closely related. Since the term extension option is within the control of the investors, they could not be forced into a term extension in which (on a present value basis) they would not be recovering substantially all of their initial net investment; therefore, the term-extending option embedded in Bond B is clearly and closely related.

If the issuer controls the term extension option, it is possible that the investor could be forced into a situation in which the investor does not recover substantially all of their initial net investment (on a present value basis), which would indicate that the term extension option is not clearly and closely related to the host contract. However, consideration should be given to whether the term extension option meets the definition of a derivative or if it would qualify for a scope exception in ASC 815 to determine if it should be bifurcated from the host contract. For host contracts other than debt hosts, ASC 815-15-25-45 requires an analysis to determine whether term extension options should be separated under ASC 815-15-25-1(a).

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Notwithstanding the guidance in ASC 815-15-25-44 and ASC 815-15-25-45, many term-extending options will not meet the definition of derivatives because they cannot be net settled. Additionally, from the perspective of the issuer of the loan agreement, a term-extending option when only the issuer/borrower has the right to extend the agreement would be considered a loan commitment and meet the scope exception for loan commitments, as described in ASC 815-10-15-69 through ASC 815-10-15-71. Therefore, many term-extending options will not have to be separated from the host

instrument, even though they may not be clearly and closely related to their host contracts because a freestanding instrument with the same terms would not meet the definition of a derivative or would be eligible for a scope exception.

***Determine whether the put or call option accelerates repayment of principal of the debt***

The reporting entity should first determine whether exercise of the put or call option accelerates the repayment of principal of the debt. ASC 815-15-25-41 provides guidance on put and call options that do not accelerate the repayment of the debt.

**ASC 815-15-25-41**

Call (put) options that do not accelerate the repayment of principal on a debt instrument but instead require a cash settlement that is equal to the price of the option at the date of exercise would not be considered to be clearly and closely related to the debt instrument in which it is embedded.

If exercise of a put or call option accelerates the repayment of the debt, further analysis is required to determine whether the put or call option is clearly and closely related to its debt host.

***Determine the nature of the settlement amount paid upon exercise of put or call option***

The reporting entity should determine if the amount paid upon exercise of a put or call option is based on changes in an index rather than simply being the repayment of principal at par or at a fixed premium or discount. For example, a put option that entitles the holder to receive an amount determined by the change in the S&P 500 index (i.e., par value of the debt multiplied by the change in the S&P 500 index over the period the debt is outstanding) is based on changes in an equity index. On the other hand, debt callable at a fixed price of 101% is not based on changes in an index. Debt callable at a price of 108% at the end of year 1, 106% at the end of year 2, and 104% at the end of year 3 is also not based on changes in an index because the call premium changes simply due to the passage of time.

If the amount paid upon exercise of a put or call option is based on changes in an index, then the reporting entity should determine whether the index is an interest rate index or credit risk (specifically, the issuer's credit). If the index is *not* an interest rate index or credit risk, the put or call option is not clearly and closely related to the debt host instrument and should be separately accounted for as a derivative under the guidance in ASC 815.

If the amount paid upon exercise of the put or call option is (1) not based on changes in an index, or (2) based on changes in an interest rate or related to the issuer's credit, further analysis is required to determine whether the put or call option is clearly and closely related.

**Question FG 1-4**

Is an embedded put or call option that if exercised, the borrower will pay the fair value of the debt upon exercise considered clearly and closely related to its host?

***PwC response***

Maybe. There are circumstances when a fair value put or call option may not be considered clearly and closely related to its debt host. For example, if a debt instrument is callable by the borrower at fair value, a lender may receive substantially less than their initial recorded investment. On the other hand, if the option is a lender-held put option, while the investor would never be forced to receive substantially less than their initial recorded investment, the put option would need to be further evaluated to determine if it is clearly and closely related to the host. However, the option generally would not have a material value because its strike price is equal to the underlying's fair value.

***Determine whether the debt instrument involves a substantial discount or premium***

Practice generally considers a discount or premium equal to or greater than 10% of the par value of the host debt instrument to be substantial. Similarly, a spread between the debt's issuance price and the price at which the put or call option can be exercised that is equal to or greater than 10% is also generally considered substantial. However, a 10% discount or premium is not a bright-line; all relevant facts and circumstances should be considered to determine whether the discount or premium is substantial. For example, if a contingent put or call option is highly likely of becoming exercisable in a short period of time after issuance, a discount or premium of less than 10% could be considered substantial. A put or call option that requires a debt instrument to be repaid at its accreted value is generally not considered to involve a substantial discount or premium.

If the put or call involves a substantial premium or discount, it should be evaluated to determine whether it is contingently exercisable. If it does not involve a substantial premium or discount, it should be further evaluated to determine whether it contains an embedded interest rate derivative that should be separated. See FG 1.6.1.2 for information on how to determine whether a debt host contract contains an embedded interest rate derivative.

***Determine whether the put or call option is contingently exercisable***

The reporting entity should then determine whether the put or call option is contingently exercisable. A debt instrument that an issuer can call upon a commodity price level reaching a specified price, bonds puttable if interest rates reach a specified level, and bonds puttable upon a change in control are examples of instruments with put and call options that are contingently exercisable.

If the put or call is contingently exercisable and meets the other requirements shown in Figure DH 4-4, the put or call is not clearly and closely related to its host debt instrument. If it is not contingently exercisable or is not otherwise required to be bifurcated under ASC 815-15-25-41 and ASC 815-15-25-42, it should be further evaluated to determine whether it contains an embedded interest rate derivative that should be separated.

***1.6.1.2 Analysis of embedded interest rate derivatives***

When an embedded interest component alters the contractual interest on its host contract, it may not be considered clearly and closely related even though they both have interest rate underlyings. For example, a debt instrument that provides a return that is positively leveraged (i.e., favorably impacted by the embedded derivative) to a significant degree may contain an embedded interest rate derivative that should be accounted for separately.

ASC 815-15-25-26 provides guidance on evaluating whether an embedded interest rate derivative is considered clearly and closely related to a debt host contract. This guidance should be applied if the only underlying of the embedded component is an interest rate or interest rate index.

### **ASC 815-15-25-26**

For purposes of applying the provisions of paragraph 815-15-25-1, an embedded derivative in which the only underlying is an interest rate or interest rate index (such as an interest rate cap or an interest rate collar) that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract that is considered a debt instrument is considered to be clearly and closely related to the host contract unless either of the following conditions exists:

- a. The hybrid instrument can contractually be settled in such a way that the investor (the holder or the creditor) would not recover substantially all of its initial recorded investment (that is, the embedded derivative contains a provision that permits any possibility whatsoever that the investor's [the holder's or the creditor's] undiscounted net cash inflows over the life of the instrument would not recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms).
- b. The embedded derivative meets both of the following conditions:
  1. There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract (that is, the embedded derivative contains a provision that could under any possibility whatsoever at least double the investor's initial rate of return on the host contract).
  2. For any of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed in (b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under the relevant future interest rate scenario) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception.

Although it could be argued that the decision to exercise a put or call option embedded in a debt instrument is based on interest rates and credit, "plain vanilla" and "non-contingent" calls are considered to be solely indexed to interest rates as contemplated in ASC 815-15-25-26.

ASC 815-15-25-29 clarifies that in the case of a put option that *permits*, but does not require, the lender to settle the debt instrument in a manner that causes it not to recover substantially all of its initial recorded investment, the guidance in ASC 815-15-25-26(a) does not apply. As illustrated in Example 10 in ASC 815-15-55-128, provisions that allow the investor to choose to accept a settlement that is substantially less than its initial investment do not conflict with ASC 815-15-25-26(a).

ASC 815-15-25-37 and ASC 815-15-25-38 clarify that in the case of a call option that *permits*, but does not require, the reporting entity to accelerate the repayment of the debt, the guidance in ASC 815-15-25-26(b) above is not applicable.

### ***Application of the test to determine whether the lender recovers substantially all of its investment***

We believe “substantially all” means approximately 90% of the investment. Therefore, if the embedded component in a debt instrument could result in the lender being required to settle the debt instrument receiving less than 90% of its initial recorded investment, it likely creates an embedded interest rate derivative that should be accounted for separately. This analysis should be performed on an undiscounted basis and consider all possible events without regard to probability.

### ***Application of the test to determine whether the lender can double its initial rate of return and double the market rate of return***

This test is commonly referred to as the double-double test. We believe the initial rate of return that should be used in the double-double test is that of the host debt instrument without the embedded derivative, not the combined hybrid instrument (debt instrument with the embedded derivative). The initial rate of return on the host debt instrument may differ from the stated initial rate of return on the hybrid instrument as the yield on the hybrid may be affected by the embedded derivative. The analysis should be performed without regard to the probability of the event occurring.

When considering transactions with multiple elements, such as debt issued with warrants, the double-double test should be performed after proceeds have been allocated to the individual transactions as discussed in FG 8.4. However, the terms of the combined transaction should be considered when performing the test. For example, if upon the exercise of a put option embedded in a debt instrument issued with warrants, the lender will receive par value for surrendering the combination of the debt and warrants, it is less likely to meet the double-double test than if the lender would receive par value for the debt and the warrants remain outstanding.

Prior to adoption of ASU 2020-06, convertible debt within the scope of the cash conversion guidance in ASC 470-20 should perform the double-double test before the bond is bifurcated, as described in FG 6.6A. Therefore, when evaluating whether an embedded put or call option should be accounted for separately, the discount created by separating the conversion option should not be considered. This will also be true after the adoption of ASU 2020-06 for convertible debt with a substantial premium. As described in FG 6.6, this guidance requires the premium to be separately recorded in APIC such that the liability would be recorded at its par value. We believe that the evaluation of whether any embedded put or call options should be accounted for separately should be performed prior to the separation between liability and APIC.

### **Question FG 1-5**

If a variable-rate debt instrument contains an interest rate floor or cap, such that the interest rate could never fall below or exceed a specified level, would the issuer be required to separate the interest rate floor or cap from the debt instrument?

#### ***PwC response***

Probably not. ASC 815-15-25-32 clarifies that interest rate caps and floors are typically considered clearly and closely related to a debt host contract. However, the analysis in ASC 815-15-25-26 should be performed. If the provisions of either ASC 815-15-25-26(a) or (b) are met, then the interest rate floor or cap must be separated from the debt instrument. In applying this guidance, caps are typically considered clearly and closely related to a debt host contract; floors are generally considered clearly and closely related to a debt host contract unless they are issued in the money.

### Question FG 1-6

A reporting entity obtains a five-year loan with an interest rate that resets every three months based on the five-year Constant Maturity Swap (CMS) index, less a constant spread. Does the loan contain an embedded derivative that should be separated from the host debt instrument?

#### ***PwC response***

Probably. A full analysis of ASC 815-15-25-26(b) would need to be performed to determine if the embedded derivative should be separated.

In this loan, the CMS index is essentially the indicated rate in effect at any point in time for the five-year point on the LIBOR swap curve. Because the debt instrument is indexed based on the LIBOR curve and has a variable interest rate that resets quarterly, the host contract may be considered to be a five-year loan with an interest rate based on three-month LIBOR that resets every three months. If the yield curve steepens sharply whereby the short-end of the LIBOR curve drops to 1% while the mid to long-end of the LIBOR curve increases to 10% or more, there could be a scenario in which the interest rate on the loan would be double the investor's initial rate of return and at the same time be twice the then market rate of return of the host contract. Based on an analysis of ASC 815-15-25-26(b), it would appear that the CMS index feature would not be clearly and closely related to the debt host. Assuming the other criteria in ASC 815-15-25-1 are met, the embedded derivative (i.e., the basis swap) would have to be accounted for separately under ASC 815.

### Question FG 1-7

A reporting entity enters into a five-year note that has an interest rate based on the ten-year Constant Maturity Treasury (CMT) index, which resets every 90 days. Does the note contain an embedded derivative that should be separated from the host debt instrument?

#### ***PwC response***

Probably. A full analysis of ASC 815-15-25-26(b) would need to be performed to determine if the embedded derivative should be separated.

The host contract in this note is a five-year debt instrument with a rate that resets every 90 days. Because the yield curve that the ten-year CMT index is based on may be flatter or steeper than the 90-day CMT index, there is a possibility that the investor will double their initial rate of return and the embedded derivative could also result in a return that is twice the then-current market return.

Some have argued that the embedded derivative in this type of structure does not meet the ASC 815-15-25-26(b) criterion by analogy to Case C in ASC 815-15-55-176 through ASC 815-15-55-178. Case C has a similar instrument (i.e., a de-levered floater) but clearly indicates that "there appears to be no possibility of the embedded derivative increasing the investor's rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract [see ASC 815-15-25-26(b)]." The conclusion in Case C was based on the specific facts in Case C (i.e., it was assumed that it was not possible for the investor to double its initial rate of return). However, when there is a possibility of the investor doubling its initial rate of return while at the same time doubling the then-current rate of return, a CMT index feature would not be clearly and closely related to the debt host; assuming the other criteria in ASC 815-15-25-1 are met, the embedded derivative (i.e., the basis swap) would have to be accounted for separately under ASC 815.

For consideration of whether interest rate reset features based on SOFR would be required to be bifurcated as an embedded derivative, please refer to DH 4.9.

### 1.6.1.3 *Application examples of embedded interest rate derivatives*

Example FG 1-2 illustrates the application of the guidance for determining whether an embedded put and call option should be separated from a debt instrument and accounted for as a derivative to debt puttable upon a change in interest rates. Example FG 1-3, Example FG 1-4 and Example FG 1-5 illustrate this analysis to debt puttable upon a change of control.

#### **EXAMPLE FG 1-2**

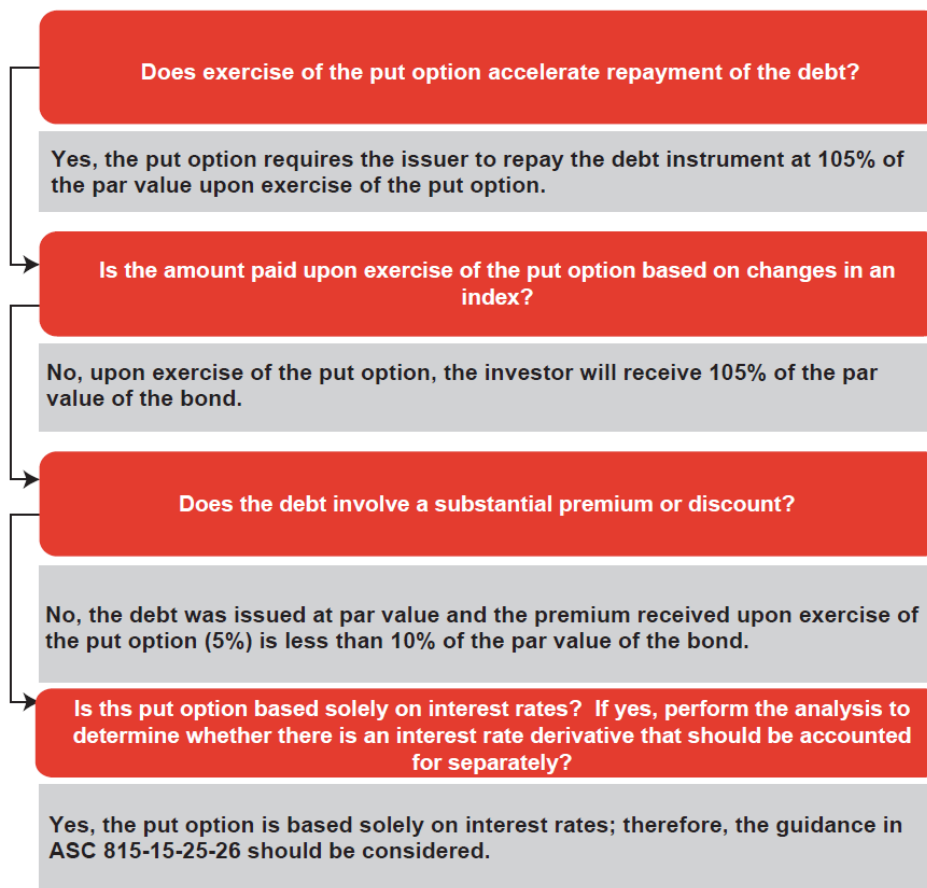
##### **Debt puttable upon a change in interest rates**

FG Corp issues a fixed-rate debt instrument with a term of five years, at par value. The debt contains a put option that allows the lender to put the debt when there is an increase in the 6-month LIBOR rate of 150 basis points or more, and receive 105% of the debt's par value.

Is the embedded put option clearly and closely related to the debt host?

##### *Analysis*

FG Corp performs the analysis in Figure 1-1 as illustrated below.





After considering the guidance in ASC 815-15-25-26(b), FG Corp would conclude that the debt has an embedded interest rate derivative that should be accounted for separately because it is possible for the investor to earn double the then-current market rate for the host debt instrument and double their initial rate of return. For example, if 6-month LIBOR increases to 151 basis points the day after the debt is issued and the investor puts the debt to the issuer for 105% of par, that could result in the issuer earning more (on an annualized basis) than the then-current market rate of return for the host debt instrument as well as doubling the investor's initial rate of return.

### EXAMPLE FG 1-3

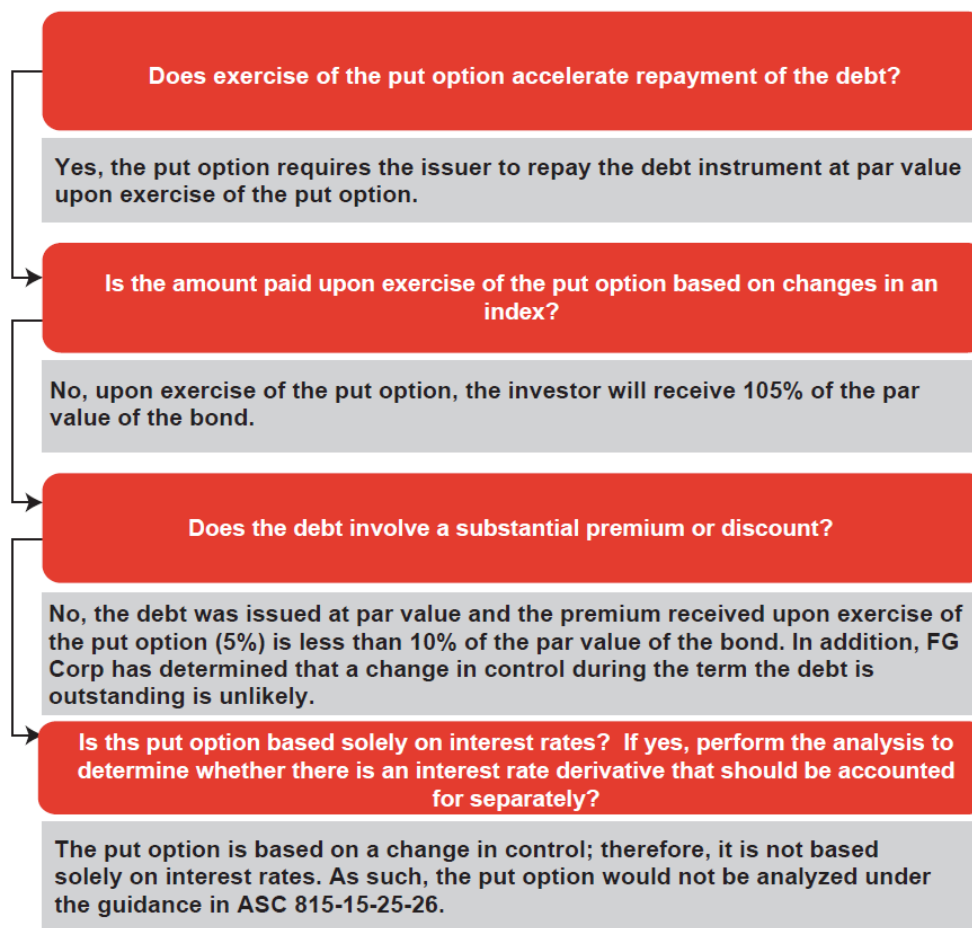
#### Debt issued at par, puttable upon a change in control

FG Corp issues a fixed-rate debt instrument with a term of five years, at par value. The debt contains a put option that allows the lender to put the debt when there is a change in control (defined in the debt agreement) and receive 105% of the debt's par value. FG Corp determines that a change in control during the next five years is unlikely.

Is the embedded put option clearly and closely related to the debt host?

#### Analysis

FG Corp performs the analysis in Figure 1-1 as illustrated below.



Based on the analysis, the embedded put option is considered clearly and closely related to its debt host. It should not be accounted for separately.

### EXAMPLE FG 1-4

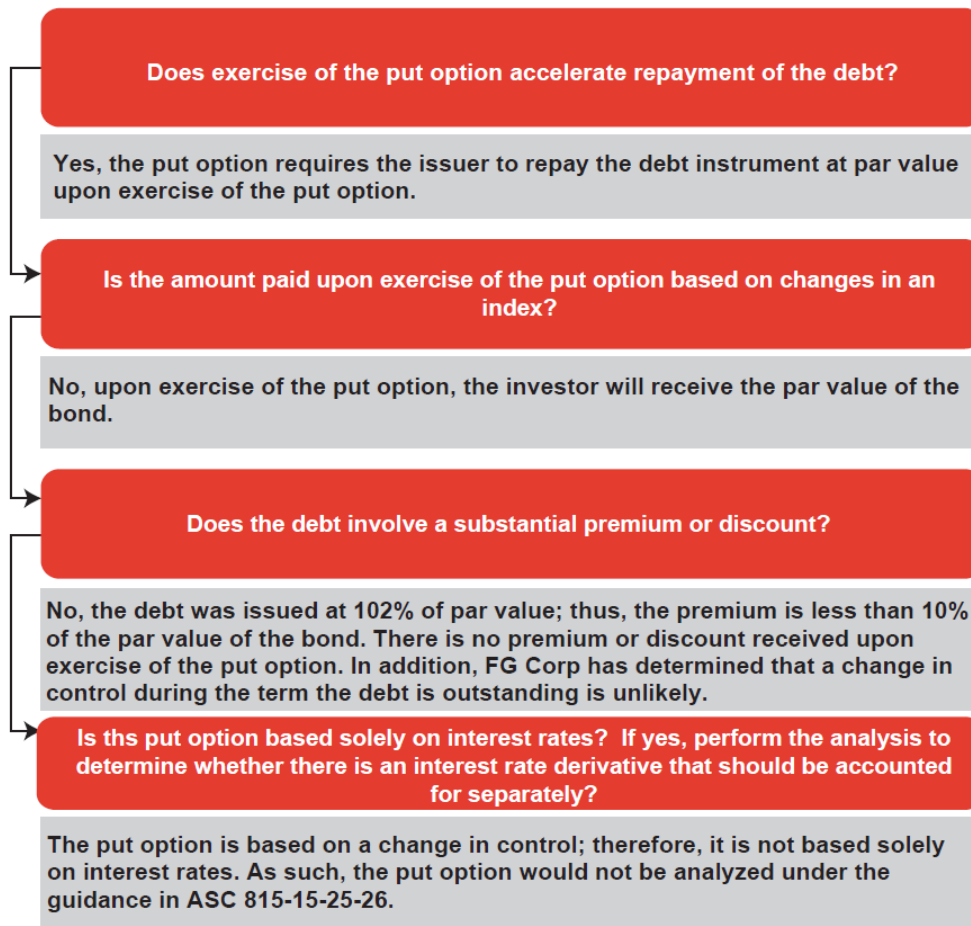
#### Debt issued at a premium, puttable upon a change in control

FG Corp issues a fixed-rate debt instrument with a term of five years, at 102% of par value. The debt contains a put option that allows the lender to put the debt when there is a change in control (defined in the debt agreement) and receive par value. FG Corp determines that a change in control during the next five years is unlikely.

Is the embedded put option clearly and closely related to the debt host?

#### Analysis

FG Corp performs the analysis in Figure 1-1 as illustrated below.



Based on the analysis, the embedded put option is considered clearly and closely related to its debt host. It should not be accounted for separately.

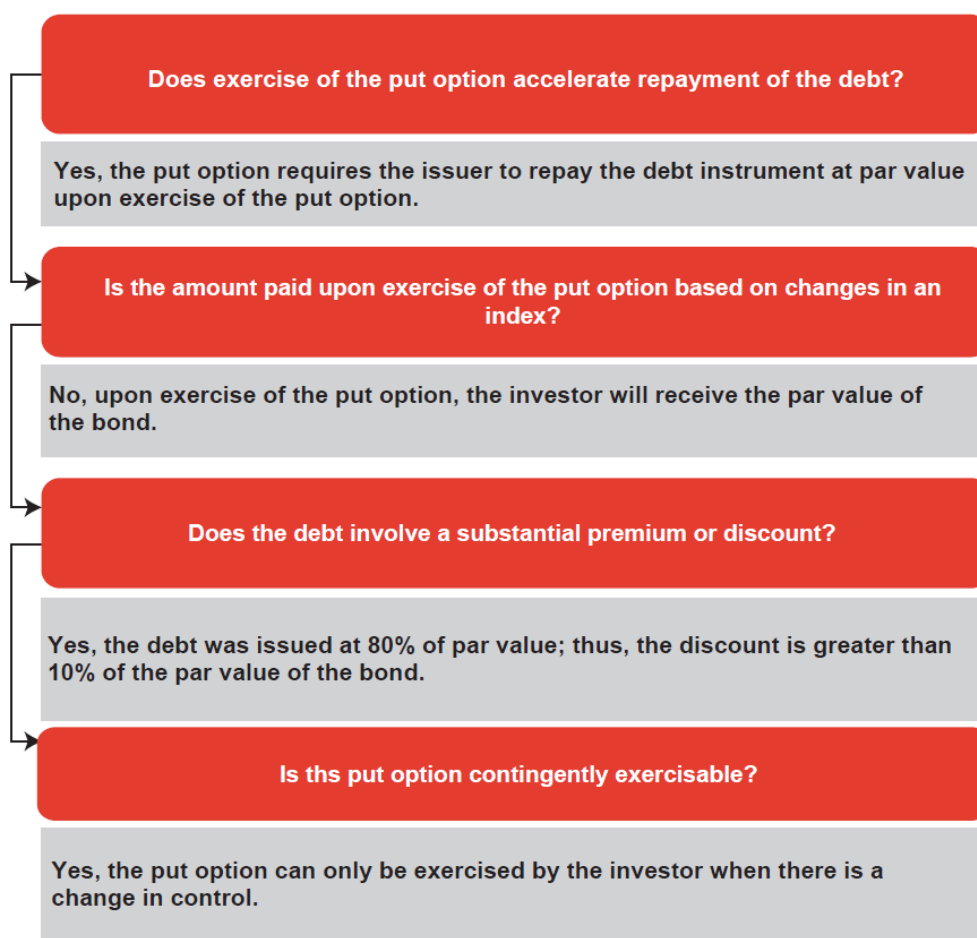
**EXAMPLE FG 1-5****Debt issued at a discount, puttable upon a change in control**

FG Corp issues a fixed-rate debt instrument with a term of five years, at 80% of par value. The debt contains a put option that allows the lender to put the debt when there is a change in control (defined in the debt agreement) and receive par value.

Is the embedded put option clearly and closely related to the debt host?

*Analysis*

FG Corp performs the analysis in Figure 1-1 as illustrated below.



Based on the analysis, the embedded put option is not considered clearly and closely related to its debt host. It should be accounted for separately as a derivative based on the guidance in ASC 815.

**1.6.2 Indexed debt instruments**

Some debt instruments have embedded components that provide for returns that are indexed to an underlying other than interest rates or the creditworthiness of the reporting entity. For example, a

debt instrument may be indexed to the price of the reporting entity's equity, creditworthiness of a referenced pool of debt securities, commodities such as oil or natural gas, or the S&P 500 index.

ASC 815-15-25-1 provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative. Embedded components which index a debt instrument to a reporting entity's own equity often qualify for the scope exception for certain contracts involving a reporting entity's own equity in ASC 815-10-15-74(a); therefore, these embedded components are generally not separated and accounted for as a derivative.

Many embedded components which index a debt instrument to an index unrelated to the reporting entity (e.g., natural gas, S&P 500) often meet the requirements for derivative separation; therefore, these instruments are often accounted for as a debt host contract and a separate derivative.

If the embedded component is not required to be separately accounted for as a derivative under ASC 815, the guidance in ASC 470-10-25-4 and ASC 470-10-35-4 should be applied to the indexed debt instrument.

#### **ASC 470-10-25-4**

If the investor's right to receive the contingent payment is separable, the proceeds shall be allocated between the debt instrument and the investor's stated right to receive the contingent payment. The premium or discount on the debt resulting from the allocation shall be accounted for in accordance with Subtopic 835-30.

#### **ASC 470-10-35-4**

As the applicable index value increases such that an issuer would be required to pay an investor a contingent payment at maturity, the issuer shall recognize a liability for the amount that the contingent payment exceeds the amount, if any, originally attributed to the contingent payment feature. The liability for the contingent payment feature shall be based on the applicable index value at the balance sheet date and shall not anticipate any future changes in the index value. When no proceeds are allocated originally to the contingent payment, the additional liability resulting from the fluctuating index value shall be accounted for as an adjustment of the carrying amount of the debt obligation.

Inflation bonds are commonly issued indexed debt instruments. In general, inflation in the economic environment for the currency in which a debt instrument is denominated is considered clearly and closely related to a debt instrument; therefore, the indexation to inflation within an inflation bond typically does not meet the requirements for derivative separation. ASC 815-15-55-202 and ASC 815-15-55-203 and Question FG 1-8 provide examples illustrating when an inflation bond should be separated into a derivative and a debt host instrument.

## Question FG 1-8

A reporting entity issues 10-year inflation-linked bonds that pay interest semiannually. The interest on the bonds is set at a fixed rate. The principal amount on the bonds is indexed to a leverage-adjusted Consumer Price Index (CPI) (the “leverage inflation feature”). That is, at the end of each semi-annual period, the principal amount on the securities will adjust based on 1.5 times the published CPI for a specific period. The interest payment is calculated by multiplying the adjusted principal by the annualized interest rate. When the securities mature, the issuer pays the greater of the original or adjusted principal.

The leveraged inflation feature is an embedded derivative because its explicit terms affect some of the cash flows required by the contract in a manner similar to a derivative.

Are the economic characteristics and risks of the leveraged inflation feature considered clearly and closely related to the economic characteristics and risks of the host contract as described in ASC 815-15-25-1(a)? For purposes of applying the clearly and closely related criterion, may the criteria in ASC 815-15-25-26 be considered in the analysis?

### ***PwC response***

No. The economic characteristics and risks of the leveraged inflation feature are not considered clearly and closely related to the economic characteristics and risks of the host contract. ASC 815-15-25-50 provides guidance on inflation-indexed contracts.

### **ASC 815-15-25-50**

The interest rate and the rate of inflation in the economic environment for the currency in which a debt instrument is denominated shall be considered to be clearly and closely related. Thus, nonleveraged inflation-indexed contracts (debt instruments, capitalized lease obligations, pension obligations, and so forth) shall not have the inflation-related embedded derivative separated from the host contract.

This guidance applies to hybrid instruments that have either their principal amounts or periodic interest payments referenced to an inflation index; however, the conclusion that an inflation provision is considered clearly and closely related to a host debt instrument only applies to nonleveraged inflation provisions. Since an inflation rate is not an interest rate, we do not believe a reporting entity may consider the criteria in ASC 815-15-25-26 as support for not separating a leveraged inflation feature from its host debt instrument.

### **1.6.3 Contingent interest**

Some debt instruments pay additional interest only when certain conditions exist. For example, the amount of interest to be paid may be based on a reporting entity’s stock price, credit rating, or dividends declared on a reporting entity’s common stock. Other contingent interest provisions include payment of additional interest contingent on the occurrence of certain events. For example, additional interest is paid to investors upon a change in tax law (e.g., changes in allowable withholding or deductions) that increases the tax obligation of certain investors.

A contingent interest feature that meets the definition of a derivative is considered clearly and closely related to a debt host when indexed *solely* to interest rates or the reporting entity’s credit risk and

other requirements are met. Consistent with the analysis of indexed debt instruments discussed in FG 1.6.2, if the contingent interest feature is based on an index that is unrelated to the reporting entity, the feature should be separated and accounted for as a derivative.

Certain contingent interest provisions that meet the definition of a registration payment arrangement are within the scope of ASC 825-20-15-3. See FG 1.7 for information on registration payment arrangements.

The determination of the likelihood of paying contingent interest should be consistent for book and tax purposes. That is, if a reporting entity determines that the value of a contingent interest feature is not material because the likelihood of payment is remote, then the same assertion should be used when determining if the interest is deductible for tax purposes. See TX 9.4.2 for information on the tax accounting considerations of contingent interest.

## 1.7 *Registration payment arrangements*

A reporting entity may execute agreements in connection with the issuance of a debt instrument. Registration rights allow the holder to require that the reporting entity file a registration statement for the resale of specified instruments and may be provided to lenders in the form of a separate agreement, such as a registration rights agreement, or included as part of an investment agreement such as an investment purchase agreement, warrant agreement, debt indenture, or preferred stock indenture. These arrangements may require the issuer to pay additional interest in the event that a registration statement is not filed or is no longer effective.

The ASC Master Glossary provides a definition of a registration payment arrangement.

### **Definition from ASC Master Glossary**

Registration Payment Arrangement: An arrangement with both of the following characteristics:

- a. It specifies that the issuer will endeavor to do either of the following:
  1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S. Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period
  2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).
- b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).

ASC 825-20-15-4 provides exceptions to the provisions of the registration payment arrangement guidance.

#### **ASC 825-20-15-4**

The guidance in this Subtopic does not apply to any of the following:

- a. Arrangements that require registration or listing of convertible debt instruments or convertible preferred stock if the form of consideration that would be transferred to the counterparty is an adjustment to the conversion ratio. See Subtopic 470-20 on debt with conversion and other options or Subtopic 505-10 on equity for related guidance.
- b. Arrangements in which the amount of consideration transferred is determined by reference to either of the following:
  1. An observable market other than the market for the issuer's stock
  2. An observable index.

For example, if the consideration to be transferred if the issuer is unable to obtain an effective registration statement is determined by reference to the price of a commodity. See Subtopic 815-15 for related guidance.

- c. Arrangements in which the financial instrument or instruments subject to the arrangement are settled when the consideration is transferred (for example, a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares that are issuable upon exercise of the warrant is not declared effective by the SEC within a specified grace period).

There is no recognition of a registration payment arrangement unless transfer of consideration under the arrangement is probable and the payment amount or a range of payment amounts can be reasonably estimated. In that case, the contingent liability under the registration payment arrangement recognized upon issuance of the debt instrument should be included in the allocation of proceeds from the related financing transaction. The remaining proceeds should then be allocated to the financial instruments issued based on the provisions of other US GAAP. For example, if a registration payment arrangement relates to debt issued with warrants, the registration payment proceeds should be recognized and measured under ASC 450, *Contingencies*, first, then the remaining proceeds should be allocated between the debt and warrants. Subsequent remeasurement of the registration payment arrangement under ASC 450 would be recorded in earnings.

Any change in the value of the estimated contingent liability should be recognized in the income statement.

#### **Question FG 1-9**

A reporting entity issues convertible debt with an initial coupon rate of 6% per annum. If the reporting entity does not complete a qualified IPO within 18 months of the convertible debt being issued, then the coupon will increase in accordance with a specified schedule set forth in the debt agreement.

How should the reporting entity account for the convertible debt with the contingent interest escalation clause?

***PwC response***

The contingent escalation clause is a contingent obligation to pay additional interest that meets the definition of a registration payment arrangement within the scope of ASC 825-20. Accordingly, the reporting entity should recognize the contingent obligation to pay additional interest using the guidance in ASC 450-20-25. That is, a liability should be recorded once payment is probable and the payment amount, or a range of payment amounts, can be reasonably estimated.

If, at issuance, payment under the contingent escalation clause is not probable (or the range of payment amounts cannot be reasonably estimated), the convertible debt should be measured without regard to the contingent obligation to pay additional interest. See FG 6 (post adoption of ASU 2020-06) or FG 6A (pre adoption of ASU 2020-06) for information on the accounting for convertible debt.

If payment under the escalation clause is probable when the debt is issued, and the payment amount or a range of payment amounts can be reasonably estimated, the proceeds received from the convertible debt should be first allocated to the contingent liability and then allocated to the convertible debt. If payment under the escalation clause becomes probable after the debt is issued, and the payment amount or a range of payment amounts can be reasonably estimated, a contingent liability should be recorded with an offsetting entry to the income statement.



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***Chapter 2:  
Guarantees and joint  
and several obligations—  
updated December 2021***

## 2.1 Overview of guarantee and joint and several liability

A guarantor may guarantee financial or operational performance for a number of reasons. Common types of guarantees include financial guarantees, performance guarantees, indemnifications, and indirect guarantees of another entity's debt. Guarantees are often embedded in purchase or sales agreements, service contracts, joint venture agreements, or other commercial arrangements.

A joint and several liability is an obligation of several parties that is enforceable, for the full amount of the obligation, against any one of the parties. For example, in a joint and several debt obligation, the lender can demand payment in accordance with the terms of the debt for the total amount of the obligation from any one, or a combination, of the obligors. Reporting entities under common control may be jointly and severally liable for an obligation; but so may unrelated reporting entities.

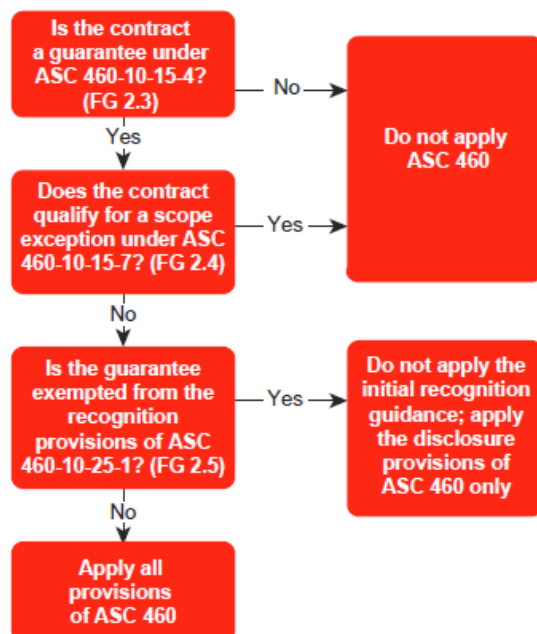
This chapter discusses the accounting considerations associated with guarantees from the perspective of the guarantor. It also discusses the accounting considerations for joint and several liability arrangements. This chapter does not discuss disclosure requirements. See FSP 23 for information related to disclosures.

## 2.2 Accounting for a guarantee under ASC 460

ASC 460, *Guarantees* contains guidance on a guarantor's accounting and disclosure requirements for particular guarantee obligations. It requires a reporting entity that makes certain types of guarantees to recognize a liability generally measured initially at fair value, and to make a number of specified disclosures. For other types of guarantees, the guarantor is exempt from the initial recognition provisions, but is still subject to the disclosure requirements. Both financial and nonfinancial contracts can be guarantees within the scope of ASC 460. The scope does not include guarantees that the guarantor should record in equity. Figure FG 2-1 summarizes the key steps in the application of ASC 460, each of which is discussed in more detail in later sections.

**Figure FG 2-1**

Framework for application of ASC 460



## 2.3 *Determining whether a contract is a guarantee*

ASC 460-10-15-4 provides a list of contract types that should be accounted for as a guarantee unless it qualifies for a scope exception. See FG 2.3.1 through FG 2.3.4 for information on each of these types of guarantees. See FG 2.4 for information on the types of guarantees excluded from the scope of ASC 460.

### **Excerpt from ASC 460-10-15-4**

Except as provided in paragraph 460-10-15-7, the provisions of this Topic apply to the following types of guarantee contracts:

- a. Contracts that contingently require a guarantor to make payments...to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.
- b. Contracts that contingently require a guarantor to make payments...to a guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees).
- c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party.
- d. Indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

Guarantees of an underlying related to an asset, liability or equity security of the guaranteed party are accounted for under ASC 460 if the underlying is a separate instrument of the guaranteed party.

The payment required to be made by guarantors is not limited to payments in cash; a guarantee can require payment in cash, financial instruments, other assets, shares of the guarantor's stock, or by providing services. Some securitizations, as well as other arrangements, may involve the subordination of the rights of some investors to the rights of others. Economically, while the subordinated investors provide credit protection, as a payment is not made, these arrangements are not in the scope of ASC 460.

Question FG 2-1 discusses if commercial letters of credit and loan commitment guarantees are within the scope of ASC 460.

### **Question FG 2-1**

Commercial letters of credit and other loan commitments are often thought of as funding guarantees. Are commercial letters of credit and loan commitments guarantees within the scope of ASC 460?

### ***PwC response***

No. Commercial letters of credit and loan commitments do not guarantee payment of an obligation and they do not provide for payment if the borrower defaults. ASC 460-10-15-4 *requires* the guarantor

to make a payment for the guarantee to be within the scope of ASC 460; many commercial letters of credit and loan commitments include material adverse change clauses that enable the guarantor to avoid making a payment. Additional information on material adverse change clauses can be found in FSP 12.

Question FG 2-2 discusses if a weather derivative is a guarantee within the scope of ASC 460.

### Question FG 2-2

Is a weather derivative a guarantee within the scope of ASC 460?

#### ***PwC response***

No. To be within the scope of ASC 460-10-15-4(a), the payments made to the guaranteed party must be based on changes in an underlying that is related to an asset, liability or equity of the guaranteed party. A geological variable is not an asset, a liability or equity of the guaranteed party. A weather derivative also does not meet the criteria in ASC 460-10-15-4(b), ASC 460-10-15-4(c) and ASC 460-10-15-4(d).

#### **2.3.1 Financial guarantees**

ASC 460-10-55-2 provides examples of financial guarantee contracts that may be within the scope of ASC 460. Insurance companies that issue financial guarantee contracts must assess whether they are within the scope of ASC 944, *Insurance*, before considering ASC 460.

#### **ASC 460-10-55-2**

The following are examples of contracts of the type described in paragraph 460-10-15-4(a):

- a. A financial standby letter of credit
- b. A market value guarantee on either a financial asset (such as a security) or a nonfinancial asset owned by the guaranteed party
- c. A guarantee of the market price of the common stock of the guaranteed party
- d. A guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity
- e. A guarantee granted to a business or its owner(s) that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified amount.

In each of these contracts, the guarantor is contingently obligated to make payment and is unable to avoid payment.

#### **2.3.1.1 Put options**

A put option is a market value guarantee. The holder of a put option has the right to sell a specified amount of an asset to the writer of the put option at a specified price on a specified date or dates. For

example, Guarantor G may provide Company X with the right to put its investment in the common stock of a private company to Guarantor G for \$10 at a future date. If the value of the common stock is below \$10 at that date, Company X would likely exercise its put option.

To determine whether a put option should be accounted for as a guarantee within the scope of ASC 460, the put option writer (i.e., the reporting entity) should first determine whether it meets the requirements to be accounted for as a derivative in ASC 815, *Derivatives and Hedging*. If so, it is not a guarantee within the scope of ASC 460. See DH 2 for information on determining whether a put option should be accounted for as a derivative, and DH 3 for information on the scope exceptions for certain financial guarantee contracts. In practice, a written put option often is not in the scope of ASC 460.

Next, the put option writer should assess whether the put option holder has an asset or liability relating to the underlying on or about inception of the put option. To meet the definition of a guarantee in ASC 460-10-15-4(a), the put option must be on an underlying related to an asset, liability or equity security of the guaranteed party (i.e., the put option holder). If the guarantor cannot conclude it is probable that the put option buyer has an asset or liability related to the underlying, then the option is not a guarantee within the scope of ASC 460. A put option also does not meet the scope criteria in ASC 460-10-15-4(b), ASC 460-10-15-4(c) and ASC 460-10-15-4(d). For purposes of measurement, the guarantor should assess whether the put option buyer still holds the asset or liability related to the underlying each period.

A put option that requires the holder to deliver the underlying instrument (i.e., a gross settled option) may be in the scope of ASC 460 if the put option is on an underlying related to an asset, liability or equity security of the guaranteed party. For instance, if an investor separately (1) buys a non-puttable bond, and (2) enters into a freestanding put option that can only be settled by delivery of the bond, the put option will be a guarantee within the scope of ASC 460 if the bond is held by the guaranteed party (unless one of the scope exceptions identified in ASC 460-10-15-7 applies).

### **2.3.1.2** *Minimum revenue guarantees*

In a minimum revenue guarantee, the revenue of a guaranteed party is guaranteed to reach a minimum amount during the guaranteed period. The revenue amount guaranteed may be total revenue, revenue from a specific product line, or some other revenue amount. A minimum revenue guarantee is typically granted to a business or its owners. The guarantor should assess whether the minimum revenue guarantee is within the scope of ASC 460.

Question FG 2-3 discusses if a licensing agreement with a guaranteed minimum royalty payment contains a guarantee within the scope of ASC 460.

### Question FG 2-3

Consider an agreement that grants a reporting entity the right to manufacture, have manufactured, purchase, sell, market and distribute the products of another entity for a one year period. Royalty payments are based on a percentage of actual sales of licensed products but there is a minimum royalty payment of \$1 million. Does the licensing agreement contain a guarantee within the scope of ASC 460?

#### ***PwC response***

Yes, a minimum royalty payment is a minimum revenue guarantee within the scope of ASC 460. The reporting entity has guaranteed that another entity will receive at least \$1 million through the royalty payment.

#### **2.3.2 Performance guarantees**

There are a number of different types of performance guarantees that may be within the scope of ASC 460. ASC 460-10-55-12 provides the following examples.

##### **ASC 460-10-55-12**

The following are examples of contracts of the type described in paragraph 460-10-15-4(b):

- a. Performance standby letters of credit
- b. Bid bonds
- c. Performance bonds
- d. Other contracts that are similar to performance standby letters of credit.

A bid bond is a type of a performance guarantee common in the construction industry, which may be within the scope of ASC 460. In a bid bond, a contractor obtains a guarantee from an insurance company or bank that the contractor will complete a project for the amount that it bids. If not, the insurance company or bank would need to pay the difference between the contractor's bid and the next closest bid. The guarantee provided by the insurance company or bank may be within the scope of ASC 460-10-15-4(b), provided that it is not excluded from that scope by ASC 460-10-15-7(d). See FG 2.4 for information on ASC 460 scope exceptions.

In a performance guarantee, the guarantor agrees to perform the obligations under a contract upon the occurrence of a specified contingent event. Those obligations may be those of the guarantor (e.g., a contractor guarantees its own past performance), or those of a third-party (i.e., a guarantor performs the obligations under a contract if the third-party cannot). See FG 2.4.3 for information on guarantees of a reporting entity's own performance.

In practice, questions often arise regarding whether certain types of performance guarantees and indemnifications are within the scope of ASC 460. A guarantor that guarantees a third party's past or future performance is in the scope of ASC 460. A guarantor can guarantee its own *past* performance under ASC 460, but a guarantor cannot guarantee its own *future* performance under ASC 460.

### 2.3.3 Indemnifications

ASC 460-10-55-13 provides three examples of indemnifications that may be a guarantee within the scope of ASC 460.

#### ASC 460-10-55-13

The following are examples of contracts of the type described in paragraph 460-10-15-4(c):

- a. An indemnification agreement (contract) that contingently requires the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law.
- b. A lessee's indemnification of the lessor for any adverse tax consequences that may arise from a change in the tax laws, because only a legislative body can change the tax laws, and the lessee therefore has no control over whether payments will be required under that indemnification. In contrast ... when a lessee indemnifies a lessor against adverse tax consequences that may arise from acts, omissions, and misrepresentations of the lessee, that indemnification is outside the scope of this Topic because the lessee is, in effect, guaranteeing its own future performance.
- c. A seller's indemnification against additional income taxes due for years before a business combination, because the indemnification relates to the seller-guarantor's past performance, not its future performance.

Example FG 2-1 illustrates an indemnification of a service provider that is within the scope of ASC 460. Example FG 2-2 illustrates a contract that indemnifies a subsidiary's past actions.

#### EXAMPLE FG 2-1

##### Indemnification of a service provider

Consumer Corp enters into a contract to obtain services from Service Inc. The terms of the contract include a provision in which Consumer Corp agrees to indemnify and "hold harmless" Service Inc for all third-party claims relating to the services provided to Consumer Corp, with the exception of any claims resulting from willful misconduct or gross negligence on the part of Service Inc.

Does the contract contain a guarantee within the scope of ASC 460?

##### *Analysis*

Yes, the indemnification is a guarantee within the scope of ASC 460 because it contingently requires Consumer Corp to make payments to Service Inc based on the occurrence of a third-party claim, which is related to a liability of Service Inc.

In this example, the indemnification relates to the performance of Service Inc, not Consumer Corp; therefore, it is not eligible for the scope exception in ASC 460-10-15-7(i) related to its own future performance. See FG 2.4 for information on scope exceptions.

**EXAMPLE FG 2-2****Indemnification of a subsidiary's past actions**

LCD Corp sells its subsidiary, Subsidiary Inc, to FG Corp. As part of the sales agreement, LCD Corp agrees to indemnify the directors and officers of FG Corp for any third-party claims and matters that may arise related to Subsidiary Inc's past actions.

Does the sales agreement contain a guarantee within the scope of ASC 460?

*Analysis*

Yes, the indemnification is a guarantee within the scope of ASC 460 because it is not dependent upon Subsidiary's (or LCD's) future performance, but rather on its past performance. LCD is guaranteeing to reimburse the directors and officers of FG Corp for any future claims related to Subsidiary Inc's past performance.

**2.3.4 Indirect guarantees of the indebtedness of others**

An indirect guarantee of indebtedness requires that the guarantor make a payment to the debtor upon the occurrence of specified events under conditions whereby (1) once the funds are transferred from the guarantor to the debtor, the funds become legally available to creditors as a result of their claims against the debtor, and (2) those creditors can enforce the debtor's claims against the guarantor under the agreement. An indirect guarantee of indebtedness ensures the borrower will have sufficient funds to repay its creditors. ASC 460-10-20 provides examples of indirect guarantees.

**Partial definition from ASC 460-10-20**

Examples of indirect guarantees include agreements to advance funds if a debtor's net income, coverage of fixed charges, or working capital falls below a specified minimum.

A guarantee of the debt of a third-party is generally within the scope of ASC 460.

**2.4 ASC 460 scope exceptions**

ASC 460-10-15-7 provides a number of scope exceptions. When a reporting entity has a contract that is not in the scope of ASC 460, it should apply other applicable US GAAP. This can result in guarantees being accounted for using a variety of different accounting standards including leasing, revenue recognition, derivatives, and insurance.

**ASC 460-10-15-7 [edits applicable upon adoption of ASC 842 or ASC 606]**

The guidance in this Topic does not apply to the following types of guarantee contracts:

- a. A guarantee or an indemnification that is excluded from the scope of Topic 450 (see paragraph 450-20-15-2—primarily employment-related guarantees).



- b. A lessee's guarantee of the residual value of the leased property at the expiration of the lease term, if the lessee (guarantor) accounts for the lease as a capital lease under Subtopic 840-30. [A lessee's guarantee of the residual value of the underlying asset at the expiration of the lease term under Topic 842.]
- c. A contract that meets the characteristics in paragraph 460-10-15-4(a) but is accounted for as contingent rent under Subtopic 840-30. [...as variable lease payments under Topic 842.]
- d. A guarantee (or an indemnification) that is issued by either an insurance entity or a reinsurance entity and accounted for under Topic 944 (including guarantees embedded in either insurance contracts or investment contracts).
- e. A contract that meets the characteristics in paragraph 460-10-15-4(a) but provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party.
- f. A contract that provides for payments that constitute a vendor rebate (by the guarantor) based on the volume of purchases by the buyer (because the underlying relates to an asset of the seller, not the buyer who receives the rebates).
- g. A guarantee or an indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction.
- h. A registration payment arrangement within the scope of Subtopic 825-20 (see Section 825-20-15).
- i. A guarantee or an indemnification of an entity's own future performance (for example, a guarantee that the guarantor will not take a certain future action).
- j. A guarantee that is accounted for as a credit derivative at fair value under Topic 815.
- k. [A sales incentive program in which a manufacturer contractually guarantees to reacquire the equipment at a guaranteed price or guaranteed prices at a specified time, or at specified time periods (for example, the entity is obligated to reacquire the equipment or the entity is obligated at the customer's request to reacquire the equipment). That program shall be evaluated in accordance with Topic 606 on revenue from contracts with customers, specifically the implementation guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78.]

Employment related guarantees such as vacation pay, pension costs, deferred compensation contracts, and stock issued to employees are generally scoped out of ASC 460.

For more information on the application and effective dates of ASC 842 and ASC 606, see PwC's guides on *Leases* and *Revenue from contracts with customers*, respectively.

#### **2.4.1 Indemnification of officers and directors**

A reporting entity may indemnify its officers or directors against litigation that arises in connection with the fulfillment of their normal functions. The indemnification is considered part of the officers' or directors' compensation package.

Since guarantees outside the scope of ASC 450 are also excluded from the scope of ASC 460, and ASC 450-20-15-2(a) excludes employment-related costs from its scope, indemnification of an officer or director against litigation is not within the scope of ASC 460.

#### **2.4.2 Guarantees that prevent sale accounting**

ASC 460-10-55-17 provides examples of guarantees that are outside the scope of ASC 460 because they prevent sale accounting.

##### **ASC 460-10-55-17 [edits applicable upon adoption of ASC 842 or ASC 606]**

The following are examples of contracts that are outside the scope of this Topic because they are of the type described in paragraph 460-10-15-7(g):

- a. A seller's guarantee of the return of a buyer's investment or return on investment of a real estate property as discussed in paragraph 360-20-40-41 [...for real estate sale-leaseback transactions]. [Subparagraph superseded by ASC 842]
- b. A seller's guarantee of a specified level of operations of a real estate property, as discussed in paragraphs 360-20-40-42 through 40-44 [...for real estate sale-leaseback transactions]. [Subparagraph superseded by ASC 842]
- c. A transaction that involves sale of a marketable security to a third-party buyer with the buyer having an option to put the security back to the seller at a specified future date or dates for a fixed price, if the existence of the put option prevents the transferor from accounting for the transaction as a sale, as described in paragraphs 860-20-55-20 through 55-23.
- d. A seller-lessee's residual value guarantee if that guarantee results in the seller-lessee deferring profit from the sale greater than or equal to the gross amount of the guarantee (see paragraphs 840-40-55-26 through 55-28). [Subparagraph superseded by ASC 842]
- e. A sales incentive program in which a manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, if that guarantee prevents the manufacturer from being able to account for a transaction as a sale of an asset, as described in paragraphs 840-10-55-12 through 55-25. (Because a manufacturer continues to recognize the residual value of the equipment it guaranteed [it is included in the seller-lessor's net investment in the lease], if the sales incentive program qualified to be reported as a sales-type lease, it still would not be within the scope of this Topic because this Topic does not apply to a guarantee for which the underlying is related to an asset of the guarantor.) [Subparagraph superseded by ASC 606]

For more information on the application and effective dates of ASC 842 and ASC 606, see PwC's guides on *Leases* and *Revenue from contracts with customers*, respectively.

### 2.4.3 **Guarantees on a reporting entity's own performance**

Guarantees related to a reporting entity's past performance are often within the scope of ASC 460. Guarantees related to a reporting entity's future performance are not. For example, product warranties for goods are within the scope of ASC 460 because the warranted product was produced and sold in the past. On the other hand, a warranty on the guarantor's future services is excluded from the scope of ASC 460 because it relates to the guarantor's own future performance. Warranties on future service include warranties on completion of a contract by a specified deadline, and service contracts that guarantee a customer a specified amount of cost savings in the future.

In some cases, a reporting entity may need to assess whether a guarantee relates to its own performance or the performance of another entity to determine whether the scope exception for a guarantee of its own future performance should be applied. If a reporting entity has guaranteed its own past performance, it should still assess whether it qualifies for other scope exceptions within ASC 460.

Example FG 2-3 illustrates a guarantee that is outside the scope of ASC 460 because it is a guarantee of a reporting entity's own future performance.

#### **EXAMPLE FG 2-3**

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##### **Indemnification of performance under a joint business arrangement**

LCD Corp and FG Corp enter into a joint business arrangement. As part of the arrangement, LCD Corp and FG Corp agree to indemnify and "hold harmless" each other from any third-party claims relating to their performance under the arrangement. Accordingly, LCD Corp agrees to indemnify FG Corp for claims related to LCD Corp's performance under the joint business arrangement, and FG Corp agrees to indemnify LCD Corp for claims related to FG Corp's performance.

Are the indemnifications guarantees within the scope of ASC 460?

##### *Analysis*

No, neither the indemnification that LCD Corp provides to FG Corp nor the indemnification that FG Corp provides to LCD Corp are within the scope of ASC 460 because each indemnification is related to the indemnitor's own future performance under the joint business arrangement.

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### 2.4.4 **Credit derivatives**

To determine whether a credit derivative is within the scope of ASC 460, a reporting entity should first determine whether the credit derivative contract should be accounted for as a derivative under the guidance in ASC 815. If the reporting entity is an insurance company, it must also consider the guidance in ASC 944. If a credit derivative is within the scope of ASC 815 or ASC 944, it should be accounted for using that guidance. If it is not within the scope of ASC 815 or ASC 944, it should be accounted for using the guidance in ASC 460.

## 2.5 Guarantees exempt from recognition under ASC 460 –updated December 2021

Certain types of guarantees are exempt from applying the recognition and measurement criteria of ASC 460. These guarantees are, however, still subject to the disclosure requirements of ASC 460. ASC 460-10-25-1 provides a list of contract types that are exempt from the recognition criteria.

### ASC 460-10-25-1 [edits applicable upon adoption of ASC 842]

The following types of guarantees are not subject to the recognition provisions of this Subsection:

- a. A guarantee that is accounted for as a derivative instrument at fair value under Topic 815.
- b. A product warranty or other guarantee for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party (see paragraph 460-10-15-9 for related guidance).
- c. A guarantee issued in a business combination or an acquisition by a not-for-profit entity that represents contingent consideration (as addressed in Subtopics 805-30 and 958-805).
- d. A guarantee for which the guarantor's obligation would be reported as an equity item rather than a liability under generally accepted accounting principles (GAAP) (see Topics 480 and 505).
- e. A guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligor (that is, principal debtor) under the original lease, as discussed in paragraph 840-30-40-5 [...in paragraph 842-20-40-3]. This exception shall not be applied by analogy to secondary obligations that are not accounted for under that paragraph [...to other secondary obligations].
- f. A guarantee issued either between parents and their subsidiaries or between corporations under common control.
- g. A parent's guarantee of its subsidiary's debt to a third-party (whether the parent is a corporation or an individual).
- h. A subsidiary's guarantee of the debt owed to a third-party by either its parent or another subsidiary of that parent.

If a reporting entity issues a guarantee within the scope of ASC 460-10-25-1 to an entity under common control, it is exempt from recording a guarantee liability in both the consolidated and its separate financial statements. However, the reporting entity should provide disclosure related to the intercompany guarantee in its separate financial statements.

For more information on the application and effective dates of ASC 842, see PwC's *Leases* guide.

Example FG 2-4 discusses whether an arrangement contains a guarantee within the scope of ASC 460 or a warranty when an unrelated third party's actions cause a monetary loss.

## EXAMPLE FG 2-4

### Guarantee in a service arrangement to identify inappropriate transactions

Identify Corp provides services to XYZ, Inc. using technology designed to identify transactions where XYZ Inc.'s customer potentially acted inappropriately causing a monetary loss to XYZ, Inc. The service arrangement includes a guarantee that if a transaction is not flagged by Identify Corp, but ultimately results in a monetary loss to XYZ, Inc., Identify Corp will pay XYZ, Inc. the amount of that loss.

Does the service agreement contain a guarantee within the scope of ASC 460?

#### *Analysis*

Yes, Identify Corp accounts for the guarantee under ASC 460. This example includes a guarantee as described in ASC 460-10-15-4, and it is not subject to any of the exceptions described in ASC 460-10-15-7 or ASC 460-10-25-1. Although Identify Corp's technology is designed to identify potentially inappropriate transactions and Identify Corp pays upon the failure of its services to do so, the amount of the payment is due to the actions of another party (i.e., customers of XYZ, Inc.); therefore, the guarantee is not a warranty of Identify Corp's service.

## 2.6 Initial measurement and recognition of a guarantee

A reporting entity that provides a guarantee is required to recognize the noncontingent component of the guarantee. They may also be required to recognize a contingent component.

The noncontingent component of a guarantee represents the obligation to stand ready to perform in the event that a specified triggering event or condition occurs. This component should be recorded as a guarantee liability at its fair value based on the guidance in ASC 460. See FG 2.6.1 for additional information.

The contingent component of a guarantee represents the obligation to make future payments if a triggering event or condition occurs. The contingent component is accounted for using the guidance in ASC 450, *Contingencies*, or in some situations, ASC 326, *Credit Losses*, as discussed in FG 2.6.2. Unlike the noncontingent component, the contingent component is only recorded if payment of the guarantee is probable, which is typically not the case at inception of the guarantee.

### 2.6.1 Initial measurement—noncontingent component of a guarantee

A guarantee recognized as a liability under the guidance in ASC 460 should be initially recognized at fair value at issuance. This is the noncontingent component of the guarantee.

When a guarantee is independently issued in a standalone arm's-length transaction with an unrelated party, it is generally recognized at an amount equal to the amount paid for the guarantee as a practical expedient.

When a guarantee is issued as part of a transaction with multiple elements (such as in conjunction with selling an asset or entering into an operating lease), the guarantor should measure the fair value by determining the amount that would have been charged to issue the same guarantee in a standalone arm's-length transaction. A reporting entity should evaluate all facts, circumstances, and business

practices to develop a process to identify guarantees included in other contracts that should be accounted for under ASC 460.

When there is no observable data for identical or similar guarantee transactions, as is often the case, the measurement of a guarantee will require the use of estimates. A reporting entity should develop valuation models which consider all relevant facts and circumstances, to determine the fair value of its guarantees. Reporting entities often use a discounted cash flow model to determine the fair value, but other models may also be appropriate.

In determining the fair value of a guarantee under ASC 460, a reporting entity should apply the principles in ASC 820, *Fair Value Measurement*. See FV 4 for additional information regarding the key concepts in applying ASC 820.

### 2.6.2 **Initial measurement—contingent component of a guarantee**

At inception of a guarantee, the guarantor should also assess the need to recognize a liability for the contingent component of the guarantee (the obligation to make future payments under the guarantee) using the guidance in ASC 450-20-25.

#### **ASC 460-10-30-3**

In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under Section 450-20-25 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of the following:

- a. The amount that satisfies the fair value objective as discussed in the preceding paragraph
- b. The contingent liability amount required to be recognized at inception of the guarantee by Section 450-20-30.

Estimated liabilities recognized using the guidance in ASC 450 are typically not discounted. That said, payments are only measured once they are considered probable. As discussed in ASC 460-10-30-4, it is unusual for the contingent liability recognized in accordance with ASC 460-10-30-3(b) to exceed the fair value amount to be recognized at inception under the guidance in ASC 460-10-30-3(a). ASC 460-10-30-4 discusses two scenarios when that may occur:

- At inception, it is probable that the guarantor will be required to pay the maximum potential settlement at the end of the term, and there is some likelihood that the guarantor will not be required to make any payment at the end of the term. Measuring the guarantee liability at fair value would require the consideration of the likelihood that no payment will be required. However, the accrual of the contingent loss under ASC 450-20-30 would be based solely on the best estimate of the probable settlement amount (the maximum potential settlement amount in this example).
- A contingent liability that is probable to occur well in the future. Under ASC 450-20-S99-1, the contingent liability is often undiscounted, which will likely exceed a guarantee liability recorded at fair value, which takes into account the time value of money.

### 2.6.2.1 **Contingent component of a guarantee under ASC 326**

The guidance in ASC 326, *Financial Instruments – Credit Losses*, was effective beginning in 2020. The guidance on the measurement of the contingent component of a guarantee not accounted for as insurance was amended when the guidance in ASC 326 became effective, as discussed in ASC 460-10-25-2 and ASC 460-10-30-5.

#### **Excerpt from ASC 460-10-25-2 (as amended)**

For guarantees that are within the scope of Subtopic 326-20, the expected credit losses (the contingent aspect) shall be measured and accounted for in addition to and separately from the fair value of the guarantee (the noncontingent aspect) in accordance with paragraph 460-10-30-5.

#### **ASC 460-10-30-5**

At the inception of a guarantee within the scope of Subtopic 326-20 on financial instruments measured at amortized cost, the guarantor is required to recognize both of the following as liabilities:

- a. The amount that satisfies the fair value objective in accordance with paragraph 460-10-30-2
- b. The contingent liability related to the expected credit loss for the guarantee measured under Subtopic 326-20.

See LI 7 and LI 13 for more information on the application and effective dates of ASC 326.

### 2.6.3 **Recognition of a guarantee**

When a reporting entity records a guarantee liability, the offsetting entry will depend on the specific facts and circumstances that gave rise to the guarantee. ASC 460 does not prescribe a specific account for the offsetting entry; however, ASC 460-10-55-23 provides illustrative examples for various types of guarantees.

#### **ASC 460-10-55-23 [edits applicable upon adoption of ASC 842]**

Although paragraph 460-10-25-4 does not prescribe a specific account, the following illustrate a guarantor's offsetting entries when it recognizes the liability at the inception of the guarantee:

- a. If the guarantee were issued in a standalone transaction for a premium, the offsetting entry would be consideration received (such as cash or a receivable).
- b. If the guarantee were issued in conjunction with the sale of assets, a product, or a business, the overall proceeds (such as the cash received or receivable) would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from the sale. That allocation would affect the calculation of the gain or loss on the sale transaction.
- c. If the guarantee were issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method, the recognition of the liability for the guarantee would result in an increase to the carrying amount of the investment.

- d. If a residual value guarantee were provided by a lessee-guarantor when entering into an operating lease, the offsetting entry (representing a payment in kind made by the lessee when entering into the operating lease) would be reflected as prepaid rent, which would be accounted for under Section 840-20-25. [Subparagraph superseded by ASC 842 (i.e., only applies to reporting entities that have not yet adopted ASC 842)]
- e. If a guarantee were issued to an unrelated party for no consideration on a standalone basis (that is, not in conjunction with any other transaction or ownership relationship), the offsetting entry would be to expense.

For more information on the application and effective dates of ASC 842, see PwC's *Leases* guide.

A reporting entity may also provide a guarantee on behalf of an equity method investee. When a reporting entity provides such a guarantee, it should evaluate whether the guarantee affects its accounting for the equity method investee. Example FG 2-5 illustrates the accounting for a guarantee made on behalf of an equity method investee.

### EXAMPLE FG 2-5

#### Guarantee of a loan made to an equity method investee

FG Corp has an equity method investment in Investee Co.

Investee Co borrowed money from Bank Corp, a third-party lender. In connection with the borrowing, FG Corp issues a guarantee of Investee Co's repayment of its loan. FG Corp is the only investor in Investee Co that issues a guarantee. FG Corp does not receive any consideration for the guarantee. Although Bank Corp would have made the loan to Investee Co without the guarantee, the cost of borrowing is reduced as a result of it. FG Corp and the other investors in Investee Co benefited from the reduced borrowing cost.

How should FG Corp account for its guarantee of Investee Co's borrowing?

#### *Analysis*

FG Corp first determines the amount of the guarantee related to its ownership interest in Investee Co by performing a pro rata calculation using the fair value of the guarantee. Based on the pro rata calculation, a portion of the guarantee will be an increase to the equity method investment, and a portion of the guarantee will be expensed. FG Corp concludes that a portion of the guarantee should be an increase to the equity method investment by analogizing to ASC 460-10-55-23(c). FG Corp concludes that the remaining portion of the guarantee should be expensed by analogizing to ASC 323, *Equity Method and Joint Ventures*. ASC 323-10-25-3 discusses the accounting when one investor grants stock-based payment awards to the employees or nonemployees of an equity method investee. The contributing investor must expense the portion of the costs of the grant that exceeds its proportionate ownership percentage.



## 2.7 *Subsequent measurement of a guarantee*

ASC 460 does not prescribe a method for subsequently measuring and recording the noncontingent guarantee liability. As stated in ASC 460-10-35-1, the guarantee liability should generally be reduced by recording a credit to net income as the guarantor is released from the guaranteed risk.

ASC 460-10-35-2 discusses three methods that can be used to subsequently recognize the guarantor's release from risk.

### **Excerpt from ASC 460-10-35-2**

Depending on the nature of the guarantee, the guarantor's release from risk has typically been recognized over the term of the guarantee using one of the following three methods:

- a. Only upon either expiration or settlement of the guarantee
- b. By a systematic and rational amortization method
- c. As the fair value of the guarantee changes.

ASC 460 does not provide guidance regarding when each of these methods should be used. A reporting entity should determine which method is most appropriate based on the nature of each guarantee. For example, the risk related to a guarantee of amortizing debt may be reduced as each payment is made. Therefore, a systematic and rational amortization method based on when the payments are made may be appropriate. A guarantor should not recognize a guarantee at fair value each period, as discussed in ASC 460-10-35-2(c), unless carrying the guarantee at fair value is appropriate based on other US GAAP (i.e., the guarantee should be accounted for under ASC 815 or the fair value option is elected).

In addition to subsequently measuring and recognizing the noncontingent component of a guarantee as discussed above, a reporting entity should continually assess the contingent component of the guarantee. The contingent component of a guarantee should be recognized using the guidance in ASC 450, unless the guarantee meets the definition of a derivative under ASC 815, is within the scope of ASC 326-20, or is considered an insurance contract under ASC 944. If so, the contingency should be accounted for using those standards. See DH 2 for further information on the definition of a derivative.

If recognition of a contingent component is required, a reporting entity should record it at the amount required by ASC 450, less the current carrying amount of the noncontingent component recognized in accordance with ASC 460. A reporting entity should separately track these components and account for them in accordance with their respective subsequent accounting guidance.

### **2.7.1 *Subsequent accounting for a guarantee under ASC 326***

The guidance regarding the subsequent measurement of a guarantee in ASC 460-10-35-4 will be amended when the guidance in ASC 326 becomes effective.

**Excerpt from ASC 460-10-35-4 (as amended)**

For guarantees within the scope of Subtopic 326-20, the expected credit losses (the contingent aspect) of the guarantee shall be accounted for in accordance with that Subtopic in addition to and separately from the fair value of the guarantee liability (the noncontingent aspect) accounted for in accordance with paragraph 460-10-30-5.

See LI 7 and LI 13 for more information on the application and effective dates of ASC 326.

## **2.8 Guarantee's effect on accounting for other transactions**

When guarantees are embedded in other contracts, a reporting entity should assess whether the guarantee affects the accounting for that contract. For example, revenue recognition could be impacted in some situations. See RR 4.3.3.9 for more information.

### **2.8.1 Guarantee's effect on the sale of a business**

It is common for a business combination to include various indemnification agreements which may meet the definition of a guarantee in ASC 460. For instance, when a seller indemnifies the acquirer from past foreign tax exposure exceeding a specified threshold, the indemnification is typically a guarantee within the scope of ASC 460. See TX 15 for further information on tax-related indemnifications. See BCG 2 for further information on indemnifications arising in a business combination.

When a reporting entity (i.e., the seller) accounts for an indemnification established by the terms of the sale of a business as a guarantee, the seller should record the guarantee liability as of the sale date. If a reporting entity recognizes a guarantee liability in connection with the sale of a business, it is asserting that its noncontingent obligation has a fair value greater than zero at the date of the sale. Such a guarantee recorded in connection with the sale of a business will affect the seller's gain or loss on the sale.

A reporting entity should also consider the likelihood of having to return any sales proceeds for violations of the representations and warranties not included in the scope of ASC 460. Absent evidence to the contrary, general representations and warranties provided as a part of the sale of a business are assumed to be valid as of the sale date, and release of the consideration from escrow is expected at the end of the escrow period. Therefore, in most cases, the amounts held in escrow for general representations and warranties would be considered part of the consideration received for the sale of the business and included in determining the gain or loss on sale.

Example FG 2-6 illustrates the effect of escrow arrangements on the accounting for the sale of a business.

### **EXAMPLE FG 2-6**

#### **Effect of escrowed proceeds on accounting for the sale of a business**

LCD Corp sells its subsidiary, Subsidiary Inc, to FG Corp for cash proceeds of \$10 million. One million of the proceeds is put into an escrow account to be used to compensate FG Corp for any violations of

the general representations and warranties listed in the purchase agreement. LCD Corp is not aware of any potential claims that may exist and has determined that the probability of a violation is insignificant (i.e., it considers the fair value of the noncontingent guarantee to be approximately zero). Barring any violations, the escrowed proceeds will be distributed to LCD Corp one year after the date of the sale.

How should LCD Corp account for the \$1 million of sales proceeds put into escrow?

### *Analysis*

LCD Corp should recognize the \$1 million of escrowed proceeds as part of the proceeds from the sale of Subsidiary Inc on the date of sale because it has determined the probability of a violation is insignificant. LCD Corp should use the entire sales price of \$10 million (which includes the \$1 million in escrow) to calculate its gain or loss on the sale of Subsidiary Inc.

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## **2.8.2 *Guarantee's effect on accounting for financial asset transfers***

A reporting entity may enter into a transaction to transfer a financial asset, a group of financial assets, or a participating interest in a financial asset. Transfers of financial assets may be accounted for by the transferor as sales or a secured borrowing. Whether a transfer of financial assets is accounted for as a sale or a secured borrowing depends on whether the transferor has relinquished control and the transferee has obtained control over the financial assets.

In assessing whether control has been transferred to the transferee, a reporting entity must consider whether the transferred financial assets have been isolated beyond the reach of the transferor, which requires assessing the continuing involvement of the transferor, if any. It is not unusual for a transferor to have continuing involvement in the form of a credit enhancement. This credit enhancement could be through a financial guarantee or retaining subordinated interests in assets sold to third parties. Having continuing involvement does not necessarily preclude a transferor from achieving sale accounting.

If a transfer of financial assets qualifies for sale accounting and the transferor provides a guarantee, it should be assessed under the guidance in ASC 460. A guarantee recorded in connection with the transfer of financial assets will affect the transferor's gain or loss on the sale. As discussed in FG 2.3, providing subordination does not qualify as a guarantee under ASC 460 if the transferor is not required to make a payment. However, if the transferor is required to make a payment to the transferee, then the arrangement may qualify as a guarantee under ASC 460.

## **2.9 *Joint and several liability***

A joint and several liability is an obligation shared by several parties that is enforceable, for the full amount of the obligation, against any one of the parties. For example, in a joint and several debt obligation, the lender can demand payment in accordance with the terms of the debt for the total amount of the obligation from any one, or a combination, of the obligors. An obligor cannot refuse to pay the total obligation on the basis that they individually only borrowed a portion of the total proceeds; however, they may be able to pursue the other obligors for repayment, depending on the agreement among the co-obligors and the laws covering the arrangement.

Joint and several liabilities can exist between entities that are under common control or between unrelated parties. Entities under common control may participate in a financing arrangement in which each entity borrows a specified amount, but are jointly and severally liable for repayment of the total debt incurred by the group. An example of joint and several liability among unrelated parties is a legal dispute when the courts hold all of the defendants jointly and severally liable for the damages awarded.

ASC 405-40, *Obligations Resulting from Joint and Several Liability Arrangements*, provides guidance on accounting for joint and several liabilities.

### **2.9.1 Joint and several obligations within ASC 405-40**

ASC 405-40-15-1 and 15-2 provide guidance on the scope of ASC 405-40.

#### **ASC 405-40-15-1**

The guidance in this Subtopic applies to obligations resulting from joint and several liability arrangements for which the total amount under the arrangement is fixed at the reporting date, except for obligations otherwise accounted for under the following Topics:

- a. Asset Retirement and Environmental Obligations, see Topic 410
- b. Contingencies, see Topic 450
- c. Guarantees, see Topic 460
- d. Compensation—Retirement Benefits, see Topic 715
- e. Income Taxes, see Topic 740.

For the total amount of an obligation under an arrangement to be considered fixed at the reporting date there can be no measurement uncertainty at the reporting date relating to the total amount of the obligation within the scope of this Subtopic. However, the total amount of the obligation may change subsequently because of factors that are unrelated to measurement uncertainty. For example, the amount may be fixed at the reporting date but change in future periods because an additional amount was borrowed under a line of credit for which an entity is jointly and severally liable or because the interest rate on a joint and several liability arrangement changed.

#### **ASC 405-40-15-2**

Although the total amount of the obligation of the entity and its co-obligors must be fixed at the reporting date to be within the scope of this Subtopic, the amount that the entity expects to pay on behalf of its co-obligors may be uncertain at the reporting date.

A reporting entity should consider its agreements to determine whether a contract creates a joint and several liability arrangement or is a guarantee. For example, a joint venture between two unrelated parties may obtain financing from a bank. If the bank is required to demand repayment from the joint venture first, and only upon nonperformance by the joint venture can the bank demand repayment from the two reporting entities that formed the joint venture, then the reporting entities may not have

joint and several liability. The reporting entities may instead have a guarantee that should be accounted for under ASC 460.

### 2.9.2 *Measurement and recognition of joint and several liabilities*

ASC 405-40-30-1 provides guidance on measuring obligations under joint and several liability arrangements, both initially and in subsequent periods. The guidance in ASC 405-40-30-1 requires a reporting entity to record, at a minimum, its portion of the joint and several liabilities. A reporting entity cannot avoid recording a liability simply because it does not believe it will pay.

#### **ASC 405-40-30-1**

Obligations resulting from joint and several liability arrangements included in the scope of this Subtopic initially shall be measured as the sum of the following:

- a. The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors.
- b. Any additional amount the reporting entity expects to pay on behalf of its co-obligors. If some amount within a range of the additional amount the reporting entity expects to pay is a better estimate than any other amount within the range, that amount shall be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range shall be the additional amount included in the measurement of the obligation.

When applying the guidance above, a reporting entity should not apply a probability weighted threshold to determine the amount it expects to pay on behalf of its co-obligors (e.g., a reporting entity should not follow a more-likely-than-not threshold).

The offsetting entry or entries (e.g., cash, an expense, a receivable, an equity transaction) will depend on the specific facts and circumstances of the transaction to which the joint and several liability arrangement relates.

Example FG 2-7 illustrates the application of the scope guidance for obligations related to joint and several liability arrangements. Example FG 2-8 illustrates the application of the scope guidance for obligations related to joint and several liability arrangements upon the issuance of a judicial ruling.

#### **EXAMPLE FG 2-7**

##### **Joint and several litigation liability arrangements**

LCD Corp and FG Corp jointly marketed a product. A lawsuit is brought against both LCD Corp and FG Corp claiming that the product posed a threat to the public. Under government laws and regulations for the product, LCD Corp and FG Corp are jointly and severally liable. The litigation is still ongoing; however, both reporting entities believe that a loss is probable and can be reasonably estimated.

Should LCD Corp and FG Corp record an obligation under ASC 405-40 as a result of their joint and several liability arrangement?

*Analysis*

No. The litigation is ongoing and therefore the obligation is not fixed at the reporting date. Since there is no fixed obligation at the reporting date, LCD Corp and FG Corp should not record a joint and several obligation. They should each record a contingency using the guidance in ASC 450.

**EXAMPLE FG 2-8***Judicial ruling*

LCD Corp and FG Corp jointly marketed a product. A lawsuit is brought against both LCD Corp and FG Corp claiming that the product posed a threat to the public. Under government laws and regulations for the product, LCD Corp and FG Corp are jointly and severally liable.

When the case is completed and a judicial ruling has been given, the total judgment is \$10 million. Under the terms of their joint and several liability arrangement LCD Corp and FG Corp are each required to pay \$5 million, but are jointly and severally liable for the total judgment amount of \$10 million. In addition, the parties must also pay interest on the award through the settlement date.

Should LCD Corp and FG Corp record a liability using the guidance in ASC 405-40?

*Analysis*

Yes. The amount is now considered fixed at the reporting date and LCD Corp and FG Corp have an obligation under a joint and several liability arrangement; therefore, they are within the scope of ASC 405-40. The fact that the award accrues interest until it is settled does not affect the conclusion that the amount of the liability has been fixed at the reporting date.

**2.9.2.1 Recoveries from co-obligors**

If a reporting entity pays an amount in excess of its share of a joint and several liability, it may be able to demand repayment from its co-obligors. ASC 405-40 does not provide guidance on recording recoveries under a joint and several liability arrangement. Depending on the facts and circumstances, a reporting entity may determine that some of the payment can be recovered, and would either record a receivable or treat the recovery as a gain contingency.

If a reporting entity has a contractual right to demand repayment from its co-obligors, then it may be appropriate to record a receivable. The receivable should be continually assessed for impairment. If the reporting entity does not have a contractual right to demand repayment, then the recovery should be treated as a gain contingency. For example, if a reporting entity does not have a contractual right to demand repayment, but intends to sue its co-obligors, then the recovery should be accounted for as a gain contingency. A reporting entity should also consider the relationship between the co-obligors to determine the appropriate accounting for the recovery. When co-obligors are related parties, a recovery may need to be accounted for as an equity or capital transaction.

Once the guidance in ASC 326 is effective, impairment of receivables will be assessed using the current expected credit loss model. See LI 7 and LI 13 for more information on the application and effective dates of ASC 326.

Example FG 2-9 and Example FG 2-10 illustrate the considerations when accounting for a recovery.

**EXAMPLE FG 2-9****Recording a joint and several liability recovery as a receivable**

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Subsidiary Inc and Branch Inc are wholly owned subsidiaries of FG Corp. Subsidiary Inc and Branch Inc collectively borrow \$50 million and are both identified as being jointly and severally obligated for the full amount of the debt in the borrowing arrangement. Subsidiary Inc uses \$20 million for its corporate purposes and Branch Inc uses \$30 million for its corporate purposes. Subsidiary Inc and Branch Inc have entered into a supplemental written agreement which enables each to obtain a recovery from the other should they pay an amount in excess of the amount of proceeds received.

The bank demands repayment in full on the debt from Subsidiary Inc, because Branch Inc is experiencing financial difficulty. Subsidiary Inc repays the full \$50 million obligation.

How should Subsidiary Inc account for the amount it is owed from Branch Inc?

*Analysis*

Subsidiary Inc should record a receivable for \$30 million because Subsidiary Inc and Branch Inc have a legally enforceable arrangement under which each party is responsible for repaying the amount it borrowed. Subsidiary Inc should assess the receivable for impairment and record an allowance for the amount considered uncollectible.

**EXAMPLE FG 2-10****Recording a joint and several liability recovery as an equity transaction**

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Subsidiary Inc and Branch Inc are wholly owned subsidiaries of FG Corp. Subsidiary Inc and Branch Inc collectively borrow \$50 million and are both identified as being jointly and severally obligated for the full amount of the debt in the borrowing arrangement. Subsidiary Inc uses \$20 million for its corporate purposes and Branch Inc uses \$30 million for its corporate purposes. Subsidiary Inc and Branch Inc have entered into a supplemental written agreement which enables each to obtain a recovery from the other should they pay an amount in excess of the amount of proceeds received.

FG Corp, the parent, directs Subsidiary Inc to write-off the amount otherwise recoverable from Branch Inc under the supplemental agreement.

How should the nonpayment by Branch Inc be recognized by Subsidiary Inc and Branch Inc?

*Analysis*

FG Corp's decision to override the terms of the agreement, which requires Branch Inc to repay Subsidiary Inc, is effectively an equity transaction between entities that are under common control. Accordingly, Subsidiary Inc should record the transaction as a dividend or a return of capital, as applicable, and not as a charge to the income statement as an uncollectible receivable. Branch Inc should similarly recognize a contribution of capital for its share of the original loan that it will not have to repay.

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***Chapter 3:  
Debt modification and  
extinguishment—updated  
December 2022***



### **3.1 Overview of debt modification and extinguishment**

A reporting entity may modify the terms of its outstanding debt by restructuring its terms or by exchanging one debt instrument for another. A debt modification may be accounted for as (1) the extinguishment of the existing debt and the issuance of new debt, or (2) a modification of the existing debt, depending on the extent of the changes.

Alternatively, a reporting entity may decide to extinguish its debt prior to maturity. This may be due to a number of reasons, including changes in interest rates, credit rating, or its capital needs.

This chapter discusses the accounting for debt modifications and exchanges, including:

- Troubled debt restructurings (TDR)
- Modifications or exchanges of term loans or debt securities
- Modifications or exchanges of lines of credit or revolving-debt arrangements
- Modifications or exchanges of loan syndications or participations

This chapter also discusses the accounting for debt defeasances and extinguishments.

### **3.2 Analyzing a debt modification**

A debt modification may be effected by:

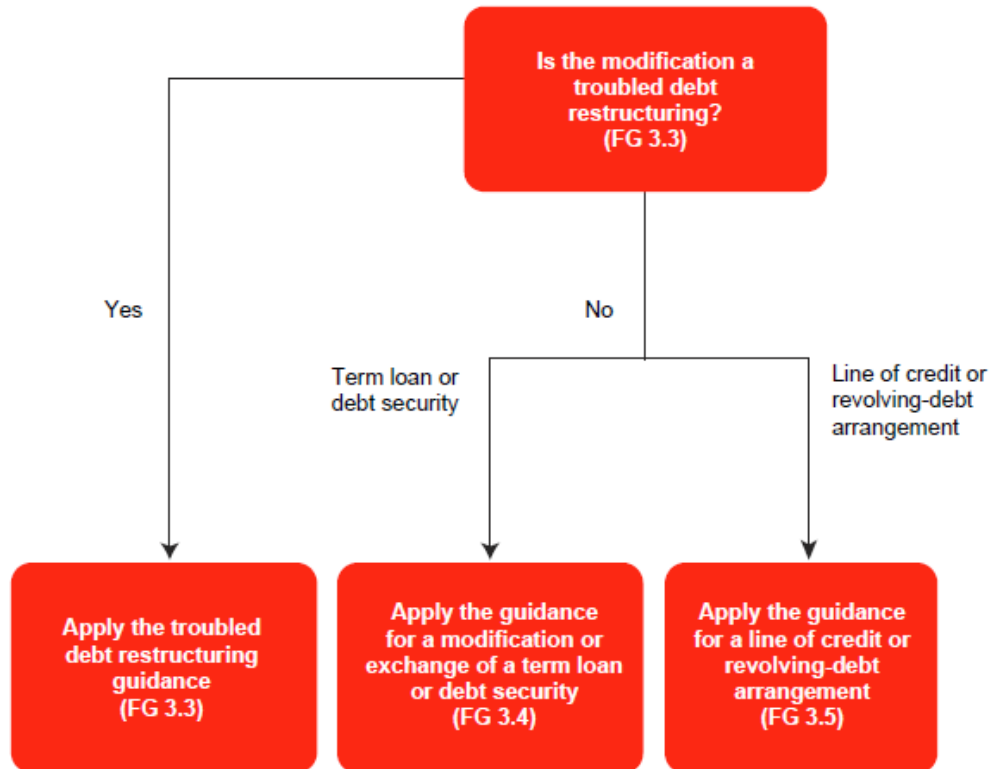
- Amending the terms or cash flows of an existing debt instrument
- Exchanging existing debt for new debt with the same lender
- Repaying an existing debt obligation and contemporaneously issuing new debt to the same lender; although this may be a legal extinguishment, the transaction may need to be accounted for as a debt modification

When a reporting entity repays an existing debt obligation using the proceeds from a contemporaneous issuance of new debt to a different lender, the transaction should be accounted for as a debt extinguishment. See FG 3.7 for information on debt extinguishment accounting.

The sale of a debt instrument from one investor to another without the involvement of the reporting entity is not a transaction that should be recognized by the reporting entity; transactions among investors involving a reporting entity's debt instruments do not affect the reporting entity's accounting.

Figure FG 3-1 illustrates the steps to determine the accounting treatment of a debt modification.

**Figure FG 3-1**  
Analyzing a debt modification



### 3.3 Troubled debt restructuring

A modification is a troubled debt restructuring (TDR) if (1) the borrower is experiencing financial difficulty, and (2) the lender grants the borrower a concession.

A debt restructuring that results in the full settlement of a debt obligation should be accounted for as a debt extinguishment; however, the borrower should still assess whether the restructuring is a TDR. Even when there is no remaining debt outstanding, the borrower is required to disclose the fact that the debt was extinguished as the result of a TDR in its financial statements. See FG 3.7 for further information on accounting for debt extinguishments.

If a borrower grants an equity interest to the lender as part of a restructuring, it should assess whether there is a change in control and whether the borrower has elected to apply pushdown accounting (see BCG 10.1 for a discussion of pushdown accounting). For example, if a reporting entity (that meets the definition of a business) experiencing financial difficulty settles its debt by giving a lender a 95% equity interest in itself, and the borrower elects push down accounting, the lender's new basis will be pushed down to the reporting entity. In that case, the TDR may be recorded differently than described in this chapter.

### Question FG 3-1

Do the amendments to ASC 310 as a result of the adoption of ASU 2022-02, *Troubled Debt Restructurings and Vintage Disclosures*, impact the borrower's accounting for troubled debt restructurings?

#### ***PwC response***

No. ASU 2022-02 amends only the guidance in ASC 310 for *creditors'* accounting for the modification of loans. While this ASU eliminated the troubled debt restructuring model for *creditors*, the ASU did *not* amend the guidance for borrowers in ASC 470. A *borrower's* evaluation and accounting for a modification of a debt instrument must still include an assessment of whether that modification should be accounted for as a troubled debt restructuring after the adoption of ASU 2022-02.

#### **3.3.1 Is the borrower experiencing financial difficulty?**

To determine whether it is experiencing financial difficulty, a borrower should first consider whether its creditworthiness has deteriorated since its debt was issued. ASC 470-60-55-7 provides the following guidance:

#### **Excerpt from ASC 470-60-55-7**

Changes in an investment-grade credit rating are not considered a deterioration in the debtor's creditworthiness for purposes of this guidance. Conversely, a decline in credit rating from investment grade to noninvestment grade is considered a deterioration in the debtor's creditworthiness for purposes of this guidance.

If a borrower issued investment-grade debt originally and the borrower's creditworthiness has not deteriorated, any modification would not be considered a troubled debt restructuring (TDR). If its creditworthiness has deteriorated since its debt was originally issued, in accordance with ASC 470-60-55-7, the borrower should assess all aspects of its current financial position to determine whether it is experiencing financial difficulty.

For debt that was noninvestment grade at time of original issuance, a borrower should qualitatively assess if its creditworthiness has deteriorated since issuance. Positive changes in any noninvestment grade credit rating since issuance is a positive factor to consider. However, some borrowers may not have current third-party credit ratings. As a result, many borrowers utilize the factors for assessing financial difficulty in ASC 470.

ASC 470-60-55-8 provides guidance on determining whether a borrower is experiencing financial difficulty. Notwithstanding those factors, if a borrower meets both of the conditions in ASC 470-60-55-9, it is *not* experiencing financial difficulty; therefore, its debt restructuring is not a TDR.

#### **Excerpt from ASC 470-60-55-9**

The following factors, if both are present, provide determinative evidence that the debtor is not experiencing financial difficulties, and, thus, the modification or exchange is not within the scope of this Subtopic (the presence of either factor individually would be an indicator, but not determinative, that the debtor is not experiencing financial difficulty):

- a. The debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a nontroubled debtor.
- b. The creditors agree to restructure the old debt solely to reflect a decrease in current market interest rates for the debtor or positive changes in the creditworthiness of the debtor since the debt was originally issued.

If a borrower does not meet these conditions, or meets only one of these conditions, it should review the indicators listed in ASC 470-60-55-8 to determine whether it is experiencing financial difficulty.

#### **ASC 470-60-55-8**

All of the following factors are indicators that the debtor is experiencing financial difficulties:

- a. The debtor is currently in default on any of its debt.
- b. The debtor has declared or is in the process of declaring bankruptcy.
- c. There is significant doubt as to whether the debtor will continue to be a going concern.
- d. Currently, the debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- e. Based on estimates and projections that only encompass the current business capabilities, the debtor forecasts that its entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity.
- f. Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

If a borrower determines that it is not experiencing financial difficulty, its debt restructuring is not a TDR. If it determines that it is experiencing financial difficulty, it should then determine whether its lender is granting a concession to determine whether the restructuring is a TDR.

#### **3.3.2 *Is the lender granting a concession?***

A lender is granting a concession when the effective borrowing rate on the restructured debt is less than the effective borrowing rate on the original debt. The effective borrowing rate of the restructured debt is calculated by solving for the discount rate that equates the present value of the cash flows under terms of the restructured debt to the current carrying amount of the original debt. ASC 470-60-55-10 through ASC 470-60-55-14 provides guidance on determining whether a lender is granting a concession.

**ASC 470-60-55-10**

A creditor is deemed to have granted a concession if the debtor's effective borrowing rate on the restructured debt is less than the effective borrowing rate of the old debt immediately before the restructuring. The effective borrowing rate of the restructured debt (after giving effect to all the terms of the restructure debt including any new or revised option or warrants, any new or revised guarantees or letter of credit, and so forth) should be calculated by projecting all the cash flows under the new terms and solving for the discount rate that equates the present value of the cash flows under the new terms to the debtor's current carrying amount of the old debt.

**ASC 470-60-55-11**

The carrying amount for purposes of this test would not include any hedging effects (including basis adjustments to the old debt) but would include any unamortized premium, discount, issuance costs, accrued interest payable, and so forth.

**ASC 470-60-55-12**

When determining the effect of any new or revised sweeteners (options, warrants, guarantees, letters of credit, and so forth), the current fair value of the new sweetener or change in fair value of the revised sweetener would be included in day-one cash flows. If such sweeteners are not exercisable for a period of time, that delay is typically considered within the estimation of the initial fair value as of the debt's modification date.

**ASC 470-60-55-13**

Although considered rare, if there is persuasive evidence that the decrease in the effective borrowing rate is due solely to a factor that is not captured in the mathematical calculation (for example, additional collateral), the creditor may not have granted a concession and the modification or exchange should be evaluated based on the substance of the modification.

**ASC 470-60-55-14**

Notwithstanding the guidance in this Section, if an entity has recently restructured the debt and is currently restructuring that debt again, the effective borrowing rate of the restructured debt (after giving effect to all the terms of the restructured debt including any new or revised options or warrants, any new or revised guarantees or letters of credit, and so forth) should be calculated by projecting all the cash flows under the new terms and solving for the discount rate that equates the present value of the cash flows under the new terms to the debtor's previous carrying amount of the debt immediately preceding the earlier restructuring. In addition, the effective borrowing rate of the restructured debt should be compared with the effective borrowing rate of the debt immediately preceding the earlier restructuring for purposes of determining whether the creditor granted a concession (that is, whether the effective borrowing rate decreased).

Example FG 3-1 illustrates the process for determining whether a lender has granted a concession.

**EXAMPLE FG 3-1****Determining whether a lender has granted a concession**

FG Corp issues a \$1,000,000 term loan on January 1, 20X2, at a discount of \$25,000.

The terms and carrying amounts of FG Corp's debt instrument as of December 31, 20X3 are:

| <b>Terms</b>            |                             |
|-------------------------|-----------------------------|
| Outstanding balance     | \$1,000,000                 |
| Remaining term          | 5 years                     |
| Maturity date           | December 31, 20X8           |
| Effective interest rate | 5.95%                       |
| Unamortized discount    | \$18,856                    |
| Net carrying value      | \$981,144                   |
| Coupon                  | 5.50%                       |
| Interest payments       | Annually in December        |
| Principal payment       | Balloon payment at maturity |

FG Corp is experiencing financial difficulty and on January 1, 20X4 negotiates a restructuring of its outstanding term loan. The following is a summary of the restructuring; there are no contingent payments in the restructured debt obligation.

| <b>Modifications made</b>                          |           |
|--|-----------|
| Principal forgiveness                              | \$100,000 |
| New coupon   | 3.00%     |
| Fair value of equity securities granted by FG Corp | \$50,000  |

Has FG Corp received a concession?

### *Analysis*

FG Corp should compare the effective interest rate of the restructured term loan with the effective interest rate of the original term loan. The effective interest rate of the restructured term loan would be determined by calculating the interest rate needed to equate the total payments on the modified debt, shown in the following table, to \$931,144 (net carrying value of \$981,144 less the \$50,000 of equity). That interest rate is 2.26%.

|                                       | 12/31/X4 | 12/31/X5 | 12/31/X6 | 12/31/X7 | 12/31/X8  | Total       |
|---------------------------------------|----------|----------|----------|----------|-----------|-------------|
| Interest payments                     | \$27,000 | \$27,000 | \$27,000 | \$27,000 | \$27,000  | \$135,000   |
| Principal payment                     | —        | —        | —        | —        | 900,000   | 900,000     |
| Total undiscounted cash flows on debt | \$27,000 | \$27,000 | \$27,000 | \$27,000 | \$927,000 | \$1,035,000 |

Because the effective interest rate is lower than the original term loan effective interest rate (5.95%), the bank has granted a concession. Because FG Corp is experiencing financial difficulty and has received a concession, the modification would be considered a troubled debt restructuring.

See Example FG 3-2 for guidance on how to record the troubled debt restructuring in this fact pattern.

### 3.3.3 Accounting for a TDR involving a modification of debt terms

When a borrower has a troubled debt restructuring (TDR) in which the terms of its debt are modified, it should analyze the future undiscounted cash flows to determine the appropriate accounting treatment. The recognition and measurement guidance for a TDR depends on whether the future undiscounted cash flows specified by the new terms are greater or less than the carrying value of the debt. In calculating the future undiscounted cash flows specified by the new terms:

- All payments under the new terms should be included
- Any contingent payments should be included without regard to the probability of those payments being made
- If the number of future payment periods may vary because the debt is payable on demand, the estimate of future cash payments should be based on the maximum number of periods that could be required under the terms of the revised debt agreement

Figure FG 3-2 summarizes the accounting treatment for a TDR which results in a modification of the debt's terms.

#### Figure FG 3-2

Accounting for a TDR resulting in a modification of terms

| If future undiscounted cash flows (including contingent payments) are: | Effect on gain recognition and interest expense  | New fees paid to lender  | New fees paid to third parties |
|--|--|--------------------------|--------------------------------|
| Less than the net carrying value of the original debt                  | <ul style="list-style-type: none"> <li>□ A gain is recorded for the difference</li> <li>□ If the lender also holds equity securities, consider whether the gain should be recorded in</li> </ul> | Reduce the recorded gain | Reduce the recorded gain       |

| If future undiscounted cash flows (including contingent payments) are: | Effect on gain recognition and interest expense   | New fees paid to lender | New fees paid to third parties |
|--|---|-------------------------|--------------------------------|
|  | <p>equity. See FG 3.3.5 for further information</p> <ul style="list-style-type: none"> <li>□ The carrying value of the debt is adjusted to the future undiscounted cash flow amount</li> <li>□ No interest expense is recorded going forward</li> <li>□ All future interest payments reduce the carrying value</li> </ul> |                         |                                |
| Greater than the net carrying value of the original debt               | <ul style="list-style-type: none"> <li>□ No gain is recorded</li> <li>□ A new effective interest rate is established based on the carrying value of the original debt and the revised cash flows</li> </ul>   | Capitalize and amortize | Expense                        |

If a TDR involves a combination of actions, such as a partial settlement of the debt and a modification of the terms, the debtor should first reduce the debt's carrying value by the fair value of the assets or equity interests transferred and then apply the modification of debt terms guidance to determine the appropriate accounting treatment.

Example FG 3-2 illustrates how to account for a TDR.

### **EXAMPLE FG 3-2**

#### **Accounting for a troubled debt restructuring**

FG Corp issues a \$1,000,000 term loan on January 1, 20X2, at a discount of \$25,000.

The terms and carrying amounts of FG Corp's debt instrument as of December 31, 20X3 are:

| <b>Terms</b>            |                   |
|-------------------------|-------------------|
| Outstanding balance     | \$1,000,000       |
| Remaining term          | 5 years           |
| Maturity date           | December 31, 20X8 |
| Effective interest rate | 5.95%             |
| Unamortized discount    | \$18,856          |
| Net carrying value      | \$981,144         |



| <b>Terms</b>      |                             |
|-------------------|-----------------------------|
| Coupon            | 5.50%                       |
| Interest payments | Annually in December        |
| Principal payment | Balloon payment at maturity |

FG Corp is experiencing financial difficulty and on January 1, 20X4 negotiates a restructuring of its outstanding term loan. The following is a summary of the restructuring; there are no contingent payments in the restructured debt obligation.

| <b>Modifications made</b>                          |           |
|--|-----------|
| Principal forgiveness                              | \$100,000 |
| New coupon   | 3.00%     |
| Fair value of equity securities granted by FG Corp | \$50,000  |

The effective interest rate of the restructured term loan is 2.26%, which equates the total cash payments on the modified debt, shown in the following table, to \$931,144 (net carrying value of \$981,144 less the \$50,000 of equity). Because this effective interest rate (2.26%) is lower than the original term loan effective interest rate (5.95%), the bank has granted a concession. FG Corp determines that its term loan restructuring is a TDR because it is experiencing financial difficulty and its lender has granted a concession.

How should FG Corp account for the TDR?

### *Analysis*

This restructuring involves both (1) a grant of equity securities from the borrower to the lender, and (2) a modification of terms. The calculation to determine if there is a gain associated with the TDR is as follows:

|  |               |
|--|---------------|
| Term loan carrying value                                     | \$981,144     |
| Less: fair value of the equity securities granted by FG Corp | (\$50,000)    |
| New net carrying value                                       | \$931,144     |
| Less: future undiscounted cash flows                         | (\$1,035,000) |
| Difference   | (\$103,856)   |

Because the future undiscounted cash flows under the new terms are greater than the adjusted net carrying value of the original debt, there is no gain to record.

A new effective interest rate is established based on the net carrying value of the debt and the revised cash flows. In this example, the new effective interest rate is 2.26%, as described in Example FG 3-1.

The following table shows the amortization of the new loan. The cash payments of \$27,000 are calculated by multiplying the new coupon of 3.00% by the new outstanding balance of \$900,000. The 12/31/X8 payment includes the balloon payment of \$900,000 on the maturity date. Interest is calculated by multiplying the effective interest rate of 2.26% by the net carrying value of the debt.

| Date         | Cash payment       | Interest         | Reduction of carrying value | Net carrying value |
|--------------|--------------------|------------------|-----------------------------|--------------------|
|              |                    |                  |                             | \$931,144          |
| 12/31/X4     | \$27,000           | \$21,047         | \$5,953                     | 925,191            |
| 12/31/X5     | 27,000             | 20,912           | 6,088                       | 919,103            |
| 12/31/X6     | 27,000             | 20,774           | 6,226                       | 912,877            |
| 12/31/X7     | 27,000             | 20,634           | 6,366                       | 906,511            |
| 12/31/X8     | 927,000            | 20,489           | 906,511                     | —                  |
| <b>Total</b> | <b>\$1,035,000</b> | <b>\$103,856</b> | <b>\$931,144</b>            |                    |

### 3.3.4 TDR of a variable-rate instrument

ASC 470-60-35-11 provides guidance for troubled debt restructurings involving an instrument with a variable interest rate.

#### **ASC 470-60-35-11**

If amounts of future cash payments must be estimated to apply the provisions of paragraphs 470-60-35-5 through 35-7 because future interest payments are expected to fluctuate—for example, the restructured terms may specify the stated interest rate to be the prime interest rate increased by a specified amount or proportion—estimates of maximum total future payments shall be based on the interest rate in effect at the time of the restructuring. Fluctuations in the effective interest rate after the restructuring from changes in the prime rate or other causes shall be accounted for as changes in estimates in the periods in which the changes occur. However, the accounting for those fluctuations shall not result in recognizing a gain on restructuring that may be offset by future cash payments (see the preceding paragraph and paragraph 470-60-35-7). Rather, the carrying amount of the restructured payable shall remain unchanged, and future cash payments shall reduce the carrying amount until the time that any gain recognized cannot be offset by future cash payments.

ASC 470-60-35-11 requires the cash interest payments used to calculate the future undiscounted cash flows to be based on the spot interest rate on the restructuring date. If the undiscounted future principal and interest payments, calculated at the restructuring date, are less than the carrying value of the debt, then a restructuring gain (equal to the difference) should be recognized. All future principal

and interest payments should be recognized as a reduction to the carrying value of the debt. As a result, interest payments are not recognized as interest expense.

In the future, when interest rates change, actual cash flows will differ from the cash flows measured at the restructuring date. The accounting treatment for changes in cash flows due to changes in interest rates depends on whether there is an increase or decrease from the spot interest rate used in the initial troubled debt restructuring (TDR) accounting (referred to as the “threshold interest rate”).

Upon an increase in interest rates, the borrower should recognize additional interest expense in the period the expense is incurred. The additional interest expense is calculated by multiplying the difference between the current rate and the threshold rate by the current carrying value of the debt for the current period only (i.e., it should not include changes in interest relative to future periods). ASC 470-60-35-11 indicates that the additional interest expense should be accounted for as a change in estimate in the period in which the change occurs.

A decrease in interest rates could result in an additional restructuring gain (or interest windfall) due to lower payments than those at the restructuring date. There is always a potential for future cash payments to offset a gain generated by an interest rate decrease (the variable rate could increase in the future); therefore, the gain should not be recognized until the debt is settled and there are no future interest payments. The cash payments are applied against the carrying amount until it is settled and there is no possibility that the gain could be reduced by future interest rate increases.

When there are subsequent increases in interest rates above the threshold interest rate after a decrease in interest rates, we believe there are various acceptable alternatives to recognize the incremental interest above the threshold rate. Figure FG 3-3 summarizes two of these methods.

### Figure FG 3-3

#### Accounting for incremental interest above the threshold rate in a TDR of a variable rate instrument

| Alternative              | Description   |
|--------------------------|---|
| Current period method    | <ul style="list-style-type: none"> <li>□ Continue to use the original threshold interest rate to determine whether increases in interest rates result in incremental interest expense</li> <li>□ Gains should be deferred until the point in time that the debt is settled and there are no future interest payments</li> </ul>   |
| Cumulative period method | <ul style="list-style-type: none"> <li>□ Record all interest payments in excess of the original threshold interest rate as a reduction of the restructured debt’s carrying value until the prior interest windfall (described above) is recaptured on a cumulative basis. Thereafter, the original threshold interest rate should be used to determine whether increases in interest rates result in incremental interest expense.</li> </ul> |

A reporting entity should choose one of these methods and apply it consistently to similar instruments; the method applied should be disclosed in the financial statements if it is material.

### 3.3.5 Restructuring of debt by existing equity holders

If a lender holds equity securities of a borrower prior to a debt restructuring, it may be considered a related party. Transactions with equity holder lenders that benefit the borrower may be deemed

capital transactions. This raises the issue of whether an extinguishment gain should be included in the borrower's income statement or reflected as a contribution of capital. To make this determination, a borrower should consider the following points, with other relevant considerations, to determine the treatment of an extinguishment gain.

- The role of the related party lender in the restructuring
- The reason the related party lender agreed to a restructuring that resulted in the borrower recognizing an extinguishment gain (i.e., why the lender agreed to accept consideration of less than fair value)
- Whether other debt holders that do not own equity agree to a restructuring under similar terms
- Whether the substance of the restructuring was the forgiveness of debt owed to a related party

There is no specific guidance related to this issue; therefore, the appropriate accounting treatment requires judgment. However, if all debt holders have equity interests in the borrower, the debt restructuring typically would be considered a capital transaction. In that case, the gain should be recorded in equity.

Determining the appropriate accounting treatment is more complicated when only some of the debt holders are also equity holders. A key consideration is whether the restructuring results in a significant shift in economics away from debt holders to equity holders. A significant transfer of value from the debt holders to different equity holders is characteristic of a typical troubled debt restructuring (TDR) and should be recognized in income. If there are significant debt holders that do not own equity, that is a strong indicator that a gain should be recorded in the income statement and not in equity.

This accounting analysis applies only to extinguishment gains. A TDR generally should not result in a loss because to qualify as a TDR, the lender has to have granted the borrower a concession.

### **3.4 *Modification or exchange – term loan and debt security***

The legal form of a modification transaction, whether a legal exchange or a legal amendment, is irrelevant for purposes of determining whether it is an accounting modification or extinguishment. The accounting treatment is determined by whether (1) the lender remains the same, and (2) the change in the debt terms is considered substantial.

A transaction involving the issuance of a new term loan or debt security to one lender (or investor) and the concurrent satisfaction of an existing term loan or debt security to another unrelated lender (or investor) is always accounted for as an extinguishment of the existing debt and issuance of new debt. See FG 3.7 for a discussion of debt extinguishment accounting and FG 1 for the accounting for the issuance of new debt. See FG 3.4.9 for information on the use of a third-party intermediary to facilitate an exchange.

Figure FG 3-4 provides a summary of the accounting for a debt modification or debt extinguishment in a restructuring or exchange transaction when the lender remains the same.

**Figure FG 3-4**

Accounting for a debt modification and debt extinguishment when the lender remains the same

| Type of transaction | Debt   | New fees paid to, or received from, existing lender    | New fees paid to third parties                  |
|---------------------|--|--|---|
| Modification        | <ul style="list-style-type: none"> <li>□ No gain or loss is recorded</li> <li>□ A new effective interest rate is established based on the carrying value of the debt and the revised cash flows</li> </ul>   | Capitalize and amortize as part of the effective yield | Expense   |
| Extinguishment      | <ul style="list-style-type: none"> <li>□ The old debt is derecognized and the new debt is recorded at fair value</li> <li>□ A gain or loss is recorded for the difference between the net carrying value of the original debt and the fair value of the new debt. See FG 3.7 for further information</li> <li>□ If the lender also holds equity securities, consider whether the gain should be recorded in equity. See FG 3.3.5 for further information</li> <li>□ Interest expense is recorded based on the effective interest rate of the new debt</li> </ul> | Expense  | Capitalize and amortize as a debt issuance cost |

ASC 470-50-40-10 and ASC 470-50-40-11 provide guidance on whether a modification or exchange of a term loan or debt security should be accounted for as a modification or an extinguishment.

**ASC 470-50-40-10**

From the debtor's perspective, an exchange of debt instruments between or a modification of a debt instrument by a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. If the terms of a debt instrument are changed or modified and the cash flow effect on a present value basis is less than 10 percent, the debt instruments are not considered to be substantially different, except in the following two circumstances:

- a. A modification or an exchange affects the terms of an embedded conversion option, from which the change in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is at least 10 percent of the carrying amount of the original debt instrument immediately before the modification or exchange.

- b. A modification or an exchange of debt instruments adds a substantive conversion option or eliminates a conversion option that was substantive at the date of the modification or exchange. (For purposes of evaluating whether an embedded conversion option was substantive on the date it was added to or eliminated from a debt instrument, see paragraphs 470-20-40-7 through 40-9.)

**ASC 470-50-40-11**

With respect to the conditions in (a) and (b) in the preceding paragraph, this guidance does not address modifications or exchanges of debt instruments in circumstances in which the embedded conversion option is separately accounted for as a derivative under Topic 815 before the modification, after the modification, or both before and after the modification.

See FG 6.8 (post adoption of ASU 2020-06) and FG 6.8A (pre-adoption of ASU 2020-06) for information on the modification of convertible debt instruments.

Cash flows can be affected by changes in principal amounts, interest rates, or maturity. They can also be affected by fees exchanged between the debtor and lender to effect changes in:

- Recourse or nonrecourse features
- Priority of the obligation
- Collateralization features, including changes in collateral
- Debt covenants or debt covenant waiver terms
- The guarantor, or elimination of the guarantor
- Option features

ASC 470-50-40-12 provides specific guidance on performing the 10% test. Key takeaways from this guidance include:

- When performing the 10% test, the cash flows of the new debt instrument should include all amounts paid by the debtor to the lender (i.e., any fees paid to the lender in conjunction with the restructuring should be included in the cash flows of the new debt instrument) as a day-one cash flow
- Third-party fees should not be included in the cash flow analysis
- If there is a variable interest rate in any of the debt instruments, the spot interest rate on the restructuring date should be used to determine future interest payments
- If either debt instrument is callable or puttable, then separate cash flow analyses should be performed assuming exercise and nonexercise of the put and call. The scenario that generates the smallest change should be used. See FG 3.4.1 for further information on prepayment options
- For debt that has been amended more than once in a twelve-month period, the debt terms that existed just prior to the earliest amendment occurring in the prior twelve months should be used

to apply the 10% test, provided modification accounting was previously applied. See FG 3.4.6 for further information

- The effective interest rate of the original debt instrument should be used to calculate the present value of the cash flows on both the new and original debt instruments

See FG 3.4.8 for information on exchanges of publicly traded debt securities, and FG 6.8 (post adoption of ASU 2020-06) and FG 6.8A (pre adoption of ASU 2020-06) for information on modifications of convertible debt instruments.

Example FG 3-3 illustrates the application of the 10% test.

### EXAMPLE FG 3-3

#### Applying the 10% test

FG Corp has a term loan that is not prepayable. Its credit rating has improved since the debt was issued, so FG Corp has decided to modify its debt to lower its borrowing costs and extend the term of its debt. Because FG Corp's credit rating has improved, this restructuring is not considered a troubled debt restructuring.

The following table summarizes the terms of the original debt and new debt on the modification date.

|                                    | <b>Original debt</b> | <b>New debt</b> |
|------------------------------------|----------------------|-----------------|
| Principal amount                   | \$5,000,000          | \$5,000,000     |
| Coupon (paid annually in December) | 5.5%                 | 5.0%            |
| Effective interest rate            | 6.0%                 | Not applicable  |
| Remaining term to maturity         | 3 years              | 5 years         |
| Lender fees                        | Not applicable       | \$200,000       |

Should FG Corp account for the changes to its debt as a modification or an extinguishment?

#### *Analysis*

To perform the 10% test, the discounted cash flows of the original debt are compared to those of the new debt as of the modification date.

#### **Cash flows on original debt**

|  |             |
|--|-------------|
| Present value of \$5,000,000 at the stated interest rate of 5.5% discounted at the original effective rate of 6% for 3 years | \$4,933,175 |
|--|-------------|

**Cash flows on new debt**

|  |                    |
|--|--------------------|
| Present value of \$5,000,000 at the new stated interest rate of 5% discounted at the original effective rate of 6% for 5 years | \$4,789,382        |
| Lender fees, undiscounted because it is a day one cash flow  | \$200,000          |
| Total cash flows   | <u>\$4,989,382</u> |

FG Corp would calculate the change in cash flows as follows:

|  |                    |
|--|--------------------|
| Present value of cash flows on new debt      | \$4,989,382        |
| Present value of cash flows on original debt | <u>\$4,933,175</u> |
| Change in present value of cash flows        | <u>\$56,207</u>    |
| Percentage change                            | <u>1.14%</u>       |

Because the change in present value of cash flows is less than 10%, the change is considered a modification.

**3.4.1 Prepayment options**

Oftentimes, debt agreements allow a borrower to prepay the debt prior to maturity; this is especially common in variable rate debt instruments and bank loan syndications. A prepayment option is a call option that gives the borrower the right to call the debt from the lender and pay the amount owed.

ASC 470-50-40-12(c) provides guidance for applying the 10% test to debt instruments with prepayment options.

**ASC 470-50-40-12(c)**

If either the new debt instrument or the original debt instrument is callable or puttable, then separate cash flow analyses shall be performed assuming exercise and nonexercise of the call or put. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10 percent threshold is met.

If the change in cash flows is less than 10% in any scenario, then the restructuring is considered a modification.

If a prepayment option (or any put or call feature) is exercisable at any time, a borrower should assume it is exercised immediately. This will usually result in the smallest change in cash flows. When including prepayment options in the 10% test, it is not necessary to assess the ability of the borrower to prepay the debt; the 10% test should be applied to all noncontingent contractual scenarios.

When applying the 10% test, it may also be appropriate to consider contingent prepayment options, such as a call option exercisable upon a change in control, or upon completion of a qualified financing.



Determining whether a contingent prepayment option should be included in a 10% test requires judgment based on the facts and circumstances at the modification date. For example, if it is probable that the contingent event that gives rise to exercise of the call option will occur, a cash flow scenario assuming exercise of the call should be performed. On the other hand, if the probability of the contingent event is remote, a contingent call or put option that is added to or deleted from a debt instrument is unlikely to be considered a substantial change and may not require further analysis.

Example FG 3-4 illustrates the application of the 10% test to a debt instrument with a prepayment option.

### EXAMPLE FG 3-4

#### Applying the 10% test to debt with a prepayment option

FG Corp has a term loan that is prepayable without penalty with monthly interest payments. Its credit rating has improved since the debt was issued in June 20X3. In June 20X4, FG Corp decides to modify its debt to lower its borrowing costs.

The following table summarizes the terms of the original debt and new debt on the modification date.

|                            | Original debt                              | New debt                                     |
|----------------------------|--|--|
| Principal amount           | \$5,000,000                                | \$5,000,000                                  |
| Coupon                     | 5.5%                                       | 5.0%   |
| Remaining term to maturity | 3 years                                    | 5 years                                      |
| Prepayment feature         | Can be prepaid at any time without penalty | Can be prepaid at any time with a 1% penalty |
| Lender fees                | Not applicable                             | \$10,000                                     |

Should FG Corp account for the change to the provisions of its debt as a modification or an extinguishment?

#### *Analysis*

To perform the 10% test, FG Corp should assume that the prepayment option in both the original and new debt is exercised on the modification date. The related cash flows on the original debt and the new debt are shown below. Because all cash flows occur on day one, the cash flows are not discounted.

#### Cash flows on original debt

|                                    |             |
|------------------------------------|-------------|
| Prepayment of debt without penalty | \$5,000,000 |
|------------------------------------|-------------|

**Cash flows on new debt**

|                                       |             |
|---------------------------------------|-------------|
| Lender fees paid                      | \$10,000    |
| Prepayment of debt                    | \$5,000,000 |
| Prepayment penalty (1% × \$5,000,000) | \$50,000    |
| Total cash flows                      | \$5,060,000 |

FG Corp calculates the change in cash flows as follows:

|                                 |             |
|---------------------------------|-------------|
| Cash flows on new debt          | \$5,060,000 |
| Cash flows on original debt     | \$5,000,000 |
| Change in cash flows            | \$60,000    |
| Percentage change in cash flows | 1.2%        |

Because the change in cash flows in the immediate prepayment scenario is less than 10%, FG Corp should account for the changes to its debt as a modification. Because the prepayment scenario resulted in modification accounting, it is not necessary to prepare a cash flow scenario that does not assume prepayment.

**3.4.2 Non-cash consideration**

ASC 470-50-40-12(a) provides guidance on the cash flows of a new debt instrument to be included in the 10% test.

**ASC 470-50-40-12(a)**

The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification.

The term “any amounts paid,” as used in ASC 470-50-40-12(a), does not indicate if the amounts must be cash, or whether non-cash consideration, such as freestanding financial instruments like warrants or preferred stock, should be considered an amount paid. We believe the fair value of non-cash consideration should be included as a day-one cash flow for purposes of determining the cash flows to be used in the 10% test. We believe the form of consideration should not affect the accounting. Treating warrants or preferred stock issued to a lender as a day-one cash flow is consistent with guidance in ASC 470-60-55-12 for troubled debt restructurings, which requires the fair value of any new or modified non-cash consideration (e.g., options, warrants, guarantees, letters of credit) to be included in the calculation to determine whether a lender is granting a concession. If non-cash consideration is not exercisable for a period of time, that delay should be considered in determining its fair value.

If a restructuring is considered a modification based on the 10% test, then any non-cash consideration should be capitalized similarly to a cash fee paid to a lender. The capitalized amount, along with any existing unamortized debt discount or premium, should be amortized as an adjustment to interest expense over the remaining term of the modified debt instrument using the effective interest method.

If a restructuring is accounted for as a debt extinguishment, then the fair value of any non-cash consideration is associated with the extinguishment of the original debt instrument (i.e., treated as an amount paid to extinguish the debt) and included in determining the extinguishment gain or loss.

A debt modification may involve changes to embedded features (e.g., covenants, collateral, or seniority position) that have no effect on cash flows. Modifications to these non-cash terms would not impact the cash flows used for the 10% test.

If a debt modification involves a modification or an exchange of a freestanding equity-classified written call option held by the same creditor, ASU 2021-04 stipulates that an increase or a decrease in the fair value of the call option held by the creditor be included in the application of the 10% test.

ASU 2021-04 also states that the increase or decrease in the fair value of the freestanding equity-classified written call option be accounted for in the same manner as any non cash consideration between the debtor and creditor as discussed in the paragraphs above. If the debt modification is accounted for as an extinguishment, the increase or decrease in fair value is included in determining the gain or loss. If the debt modification is accounted for as a modification, the increase or decrease in fair value should be treated as a capitalized cost and amortized as an adjustment of interest expense.

Refer to FG 8.3 for further discussion on ASU 2021-04.

#### **3.4.2.1 *Non-cash consideration issued to third party advisors***

If the non-cash consideration (e.g., warrants or preferred stock) is issued to third-party advisors rather than the lender, we believe the fair value of the non-cash consideration should be accounted for following the guidance in ASC 470-50-40-18 for third-party costs. The accounting for third-party costs depends upon whether the restructuring is accounted for as a modification or an extinguishment. See Figure FG 3-4 for further information.

ASU 2021-04 noted that an increase in the fair value of a freestanding equity-classified written call option held by a third party that is modified directly related to a modification of a debt instrument needs to be accounted for in the same manner as third-party costs in ASC 470-50-40-18. Refer to FG 8.3 for further discussion on ASU 2021-04.

#### **3.4.3 *Change in currency of the debt***

If a debt instrument is modified such that the currency in which it is denominated changes, the change in currency should be included in the cash flows as part of the 10% test. To convert the cash flows on the new debt into the currency of the original debt, we believe there are two acceptable methods, use (1) the spot rate in effect at the debt modification or exchange date, or (2) the forward rates corresponding to each cash flow (i.e., interest payment and principal) payment date.

### 3.4.4 *Restructured debt as the hedged item in a fair value hedge*

When performing the 10% test, the effect of the required amortization of basis adjustments due to the application of fair value hedge accounting should be ignored for the purposes of calculating the effective interest rate of the original debt instrument. The goal of the 10% test is to determine whether the terms of the relationship between the debtor and lender before and after a modification or exchange are substantially different. The fact that the debtor designated the debt as the hedged item in a fair value hedging relationship does not affect the relationship between the debtor and lender.

### 3.4.5 *Change in principal*

Application of the guidance to a term loan debt restructuring is more complicated when the principal balance changes as a result of the restructuring. Increases and decreases in the principal balance of a loan should be included in the cash flows of the new debt used to perform the 10% test based on the guidance in ASC 470-50-40-12(a), which specifically refers to considering “any” amounts paid or received by the debtor. If the principal received is net of a discount, the principal amount net of the discount should be used as the principal balance for purposes of applying this guidance.

An increase in principal should be treated as a day-one cash inflow in the cash flows of the new debt instrument, and a decrease should be treated as a day-one cash outflow.

A borrower should account for unamortized fees, new creditor fees, and third-party costs in the same manner it would had there not been a change in principal. That is, when a loan is modified, unamortized fees should continue to be deferred, new creditor fees should be capitalized and amortized as part of the effective yield and new fees paid to third parties should be expensed. When a loan is extinguished, unamortized fees and new creditor fees should be expensed, and new fees paid to third parties should be capitalized and amortized as debt issuance costs associated with the new debt. See Example FG 3-7 for an illustration of the application of this guidance.

### **Question FG 3-2**

If a borrower pays-down a portion of its debt in accordance with an existing prepayment option, can a portion of the unamortized debt issuance costs associated with the debt balance be expensed?

#### ***PwC response***

It depends on the borrower’s accounting policy.

Some borrowers continue to defer the unamortized debt issuance costs when they pay down a portion of their debt in connection with a modification (which is accounted for as a modification), based on the view that the prepayment is factored into the terms agreed to on the modified debt. In other words, they believe it is not possible to separately identify the prepayment amount.

Other reporting entities have a policy of expensing the portion of the unamortized costs associated with the partial pay down based on the guidance in ASC 470-50-40-2 because the debt has been partially settled. Since the debt has been partially settled, these reporting entities believe it is appropriate to consider the debt extinguishment guidance for the partial settlement. See FG 3.7.1 for discussion on the treatment of unamortized costs in a partial pay down.

This policy choice is not available when the original debt does not have an existing prepayment option or for a prepayment of debt made outside of a debt modification. See FG 3.7.1 for information on how unamortized fees should be accounted for in these circumstances.

### 3.4.6 *Debt restructured more than once in one-year period*

As discussed in ASC 470-50-40-12(f), if a debt instrument is restructured more than once in a twelve-month period, the debt terms (e.g., interest rate, prepayment penalties) that existed just prior to the earliest restructuring in that twelve-month period should be used to apply the 10% test, provided all previous restructurings in that twelve-month period were accounted for as a modification.

Example FG 3-5 illustrates the application of the 10% test when debt has been restructured multiple times within a twelve-month period and the debt was prepayable at any time both prior to and after any modification.

#### **EXAMPLE FG 3-5**

##### **Multiple refinancing within a one-year period for prepayable debt**

FG Corp has a term loan with monthly interest payments that is prepayable without penalty. Its credit rating has improved since the debt was issued in December 20X3. In June 20X4, FG Corp modified its debt to lower its borrowing costs.

FG Corp restructures its term loan again in December 20X4. After both modifications, the debt remained prepayable at any time, but a prepayment penalty was added.

The following table summarizes the terms of the original debt and new debt on the restructuring dates.

|                            | <b>Original debt</b>                       | <b>June 20X4 amendment</b>                                      | <b>December 20X4 amendment</b>                        |
|----------------------------|--|---|---|
| Principal amount           | \$5,000,000                                | \$5,000,000   | \$5,000,000   |
| Coupon                     | 5.5%                                       | 5.0%  | 4.5%  |
| Effective interest rate    | 6.0%                                       | Not applicable  | Not applicable  |
| Remaining term to maturity | 3.5 years remaining as of June 20X4        | 5.5 years (maturity extended by 2 years in June 20X4 amendment) | 5 years (maturity unchanged from June 20X4 amendment) |
| Prepayment feature         | Can be prepaid at any time without penalty | Can be prepaid at any time with a 1% penalty                    | Can be prepaid at any time with a 3% penalty          |
| Lender fees                | Not applicable                             | \$10,000  | \$5,000   |

Should FG Corp account for the restructuring of its debt as a modification or an extinguishment?

*Analysis*

The cash flows used in each respective 10% test are as follows:

**June 20X4 restructuring:** The June 20X4 restructuring was accounted for as a modification. The cash flows used in that 10% test are shown below.

|                                     |                 |
|-------------------------------------|-----------------|
| Cash flows on new debt <sup>1</sup> | \$5,060,000     |
| Cash flows on original debt         | \$5,000,000     |
| Change in cash flows                | <u>\$60,000</u> |
| Percentage change in cash flows     | <u>1.2%</u>     |

<sup>1</sup> The cash flows on new debt consist of the prepayment of the principal amount of \$5,000,000, the prepayment penalty of \$50,000 (1% of principal), and the lender fees paid of \$10,000

**December 20X4 restructuring:** Because the December 20X4 restructuring was done less than twelve months after the June 20X4 restructuring (which was accounted for as a modification), FG Corp must consider the terms that existed just prior to the June 20X4 restructuring (because there were no other restructurings within twelve months of December 31, 20X4 and prior to June 20X4) when determining the cash flows of the original debt. FG Corp should compare the terms following the December restructuring to the terms that existed immediately prior to the June 20X4 modification and include lender fees paid for all modifications during those twelve months to determine if together these two restructurings resulted in more than a 10% change in cash flows as compared to the original debt. Since the original debt and the modified debt are prepayable at any time, FG Corp would calculate the cash flows for this test as follows.

**Cash flows on original debt**

|                     |             |
|---------------------|-------------|
| Original cash flows | \$5,000,000 |
|---------------------|-------------|

**Cash flows on new debt**

|  |                    |
|--|--------------------|
| Lender fees paid in June 20X4 restructuring <sup>1</sup> | \$10,296           |
| Lender fees paid in December 20X4 restructuring          | 5,000              |
| Prepayment of debt <sup>2</sup>                          | 5,000,000          |
| Prepayment penalty (3% × \$5,000,000) <sup>2</sup>       | <u>150,000</u>     |
| Total cash flows   | <u>\$5,165,296</u> |

<sup>1</sup>The lender fees paid in June 20X4 have been accreted at the original effective interest rate (6%) to the December 20x4 restructuring date.

<sup>2</sup> Assumes prepayment of the principal amount of \$5,000,000 on the restructuring date in December 20X4.

FG Corp calculates the change in cash flows as follows:

|  |                  |
|--|------------------|
| Cash flows on new debt – December 20X4 restructuring | \$5,165,296      |
| Revised cash flows on original debt                  | \$5,000,000      |
| Change in cash flows                                 | <u>\$165,296</u> |
| Percentage change in cash flows                      | <u>3.3%</u>      |

Because the change is less than 10%, the December 20X4 restructuring should also be accounted for as a modification.

### **3.4.7 Multiple debt instruments held by one lender**

A borrower may have several debt instruments outstanding with one lender. When performing the 10% test, there is a general presumption that all of a lender's debt instruments should be included whether the debt was modified or not in order to accurately capture the economics of the transaction. However, in certain limited fact patterns, when it is clear that a modification is done without regard to other debt outstanding with the lender, it may be appropriate for a reporting entity to exclude certain debt instruments with the lender when performing the 10% test.

For example, if a borrower has two debt instruments outstanding with one lender, Tranche A and Tranche B, and the borrower (1) increases the principal balance of Tranche A, and (2) pays off Tranche B, the borrower should perform the 10% test by combining the cash flows of the original Tranche A and Tranche B debt instruments and comparing the combined cash flows to the new cash flows of the restructured Tranche A. When discounting the cash flows of the restructured Tranche A, we believe a weighted average effective interest rate based on the original Tranche A and Tranche B interest rates should be used.

See FG 3.6.1 for information on costs associated with the concurrent modification of non-revolving (i.e., term debt) and revolving debt arrangements.

### **3.4.8 Publicly traded or certain private placement debt securities**

ASC 470-50-55-3 provides guidance on applying the guidance in ASC 470-50-40 to publicly traded debt securities.

#### **ASC 470-50-55-3**

In a public debt issuance, for purposes of applying the guidance in this Subtopic, the debt instrument is the individual security held by an investor, and the creditor is the security holder. If an exchange or modification offer is made to all investors and only some agree to the exchange or modification, then the guidance in this Subtopic shall be applied to debt instruments held by those investors that agree to the exchange or modification. Debt instruments held by those investors that do not agree would not be affected.

There is no guidance on how to account for a refinancing of publicly traded debt securities that does not involve an exchange or modification offer (i.e., when a reporting entity issues new debt securities to investors, which potentially may include holders of the issuer's existing debt securities, and uses the proceeds to pay off existing publicly-traded debt securities potentially held by the same investors). If a literal interpretation of ASC 470-50-55-3 is applied, each individual investor should be evaluated to determine whether the individual investor holds both the new and old debt securities. When the debt securities are publicly traded, this determination may be impossible because the borrower is not privy to the ultimate lender information. In that case, we believe it is reasonable to consider the substance rather than the form of the transaction. Unless the facts and circumstances indicate otherwise, we believe it is reasonable to assume that the investors in a new publicly-traded debt security are not the same as the investors in an existing publicly-traded debt security; therefore, the refinancing of publicly-traded debt securities should be accounted for as an extinguishment. This guidance may also be applicable to private placement debt instruments (e.g., 144A bond offering) depending on the specific facts and circumstances and the information reasonably available with respect to the identities of the old and new investors.

Similar accounting may be appropriate for “refunding” transactions on tax-exempt municipal bonds. If the tax-exempt municipal bond is widely held, it may be reasonable to conclude that an extinguishment has occurred. See NP 11.4.1 for additional information.

#### **3.4.9 *Third-party intermediaries***

A third-party intermediary (e.g., an investment bank) may arrange a debt modification or exchange offer for a reporting entity. For example:

- A reporting entity has multiple bonds issued under a single bond offering outstanding; the bonds are held by a number of third-party investors
- An investment bank and reporting entity negotiate a modification to the terms of the bonds
- The investment bank buys the bonds from the third-party investors
- The terms are then modified pursuant to the modification agreement
- The investment bank sells the new bonds under the modified terms to third-party investors (who may, or may not, be the same as the investors in the original bonds)

To determine the appropriate accounting treatment for a modification or exchange transaction arranged by a third-party intermediary, a reporting entity should determine whether the intermediary is a principal to the transaction (i.e., the investor in the bonds whose terms were modified) or the reporting entity's agent (i.e., facilitating a refunding of the old bonds on behalf of the reporting entity through issuance of new debt).

ASC 470-50-55-7 provides indicators to be considered in evaluating whether a third-party intermediary is acting as principal or an agent.



**ASC 470-50-55-7**

Transactions between a debtor and a third-party creditor should be analyzed based on the guidance in paragraph 405-20-40-1 and the guidance in this Subtopic to determine whether gain or loss recognition is appropriate. Application of the guidance in this Subtopic may require determination of whether a third-party intermediary is an agent or a principal and consideration of legal definitions may be helpful in making that determination. Generally, an agent acts for and on behalf of another party. Therefore, a third-party intermediary is an agent of a debtor if it acts on behalf of the debtor. In addition, an evaluation of the facts and circumstances surrounding the involvement of a third-party intermediary should be performed. The following indicators should be considered in that evaluation:

- a. If the intermediary's role is restricted to placing or reacquiring debt for the debtor without placing its own funds at risk, that would indicate that the intermediary is an agent. For example, that may be the case if the intermediary's own funds are committed and those funds are not truly at risk because the intermediary is made whole by the debtor (and therefore is indemnified against loss by the debtor). If the intermediary places and reacquires debt for the debtor by committing its funds and is subject to the risk of loss of those funds, that would indicate that the intermediary is acting as principal.
- b. In an arrangement where an intermediary places notes issued by the debtor, if the placement is done under a best-efforts agreement, that would indicate that the intermediary is acting as agent. Under a best-efforts agreement, an agent agrees to buy only those securities that it is able to sell to others; if the agent is unable to remarket the debt, the issuer is obligated to pay off the debt. The intermediary may be acting as principal if the placement is done on a firmly committed basis, which requires the intermediary to hold any debt that it is unable to sell to others.
- c. If the debtor directs the intermediary and the intermediary cannot independently initiate an exchange or modification of the debt instrument, that would indicate that the intermediary is an agent. The intermediary may be a principal if it acquires debt from or exchanges debt with another debt holder in the market and is subject to loss as a result of the transaction.
- d. If the only compensation derived by an intermediary from its arrangement with the debtor is limited to a preestablished fee, that would indicate that the intermediary is an agent. If the intermediary derives gains based on the value of the security issued by the debtor, that would indicate that the intermediary is a principal.

There is a general presumption that a third-party intermediary is acting as an agent; however, this presumption can be overcome. The first indicator in ASC 470-50-55-7 is the most important; the third-party intermediary should be exposed to market risk to conclude it is acting as principal to the transaction. A reporting entity should evaluate all of the facts and circumstances to determine whether the third-party intermediary has funds at risk with regard to both the old bonds and new bonds. The following points should be considered.

- **The period the third-party intermediary will hold the new debt instruments before selling them.** The holding period should be long enough to expose the third-party intermediary to sufficient market risk to conclude it is a principal to the transaction; how long that period is will vary from transaction to transaction. For example, if a third-party intermediary holds debt instruments for less than one day (that is, buying the bonds and reselling them intra-day or

obtaining bids prior to, or concurrent with, an exchange), it is generally not subject to sufficient market risk to be a principal to the transaction.

- **Whether the new debt instruments will be sold on a best-efforts or firmly committed basis.** A third-party intermediary may be acting as principal if the debt instruments are sold on a firmly committed basis, which requires the bank to hold any debt instruments that it is unable to sell to others. On the other hand, when a third-party intermediary sells new debt instruments under a best-efforts agreement it indicates that the bank is acting as the reporting entity's agent. Under a best-efforts agreement, an agent agrees to buy only those debt instruments that it is able to sell to others; if the agent is unable to sell the debt instruments, the reporting entity is obligated to buy the debt instruments back.
- **Computation of the fee to be paid to the third-party intermediary by the reporting entity.** If the third-party intermediary sets the interest rate on the new debt so that it is commensurate with the combined market and credit risk to which it is exposed, without including costs for hedging that risk, the third-party intermediary may be considered a principal to the transaction. On the other hand, if a third-party intermediary includes the cost of hedging its market risk associated with holding the new debt during the agreed-upon minimum holding period, it has not placed its own funds at risk, and is acting as the reporting entity's agent. In addition, if the underwriting fees paid to the third-party intermediary by the reporting entity are higher than in similar market transactions, the reporting entity should assess whether the third-party intermediary is exacting a higher fee to reduce its exposure to market risk. In that case, the third-party intermediary may have limited its funds at risk, and may be acting as the reporting entity's agent.

If the third-party intermediary acts as an agent, the reporting entity has refinanced the original debt with new debt to other third-party investors and the reporting entity should consider the guidance in FG 3.4.8.

If the third-party intermediary is considered a principal to the transaction, it is the investor. In that case, the reporting entity should perform the 10% test based on the cash flows of the debt held by the third-party intermediary before and after the modification or exchange.

### **3.4.10 *Allocating debt issuance costs to issue and extinguish debt***

When a reporting entity issues new debt and uses the proceeds to pay off existing debt, it may incur issuance costs with the same party to (1) issue the new debt, and (2) reacquire the existing debt. For example, a reporting entity may use the same advisor to issue a tender offer for its existing debt and a private placement of its new debt. If the costs associated with each transaction are not separately identifiable, the reporting entity should allocate the total costs incurred between the issuance of the new debt and the reacquisition of the existing debt, on a rational basis.

### **3.4.11 *Fees paid in advance of restructuring of debt***

A reporting entity may incur costs directly related to a debt modification or exchange that crosses a reporting period. To determine whether the costs should be capitalized as a prepaid expense or expensed in the period incurred, a reporting entity should consider the guidance in ASC 340-10-S99-1, *SAB Topic 5.A, Expenses of Offering*. Although this guidance relates to costs incurred in advance of an equity offering, we believe it can be analogized to costs incurred in advance of a debt restructuring. Based on that analogy, we believe that fees directly related to a debt restructuring incurred in advance

of finalizing the transaction should be capitalized as a prepaid expense until the restructuring is finalized, unless facts and circumstances indicate that it is probable that the restructuring will be aborted or it is probable that the fees will be required to be expensed once the transaction is finalized in the subsequent period under the guidance in ASC 470-50-40. If it is probable that the restructuring will be aborted or that the fees will be expensed in the following period, they do not meet the definition of an asset (i.e., there is no present right to an economic benefit) and should not be capitalized.

For example, if a reporting entity incurred legal fees in advance of a debt restructuring and it finalized the debt restructuring transaction shortly after the balance sheet date, the reporting entity would likely have the information to assess the transaction using the guidance in ASC 470-50-40. If the reporting entity determined that the debt restructuring should be accounted for as a modification in the subsequent period, that guidance would require that all third-party fees be expensed. Therefore, by analogy to ASC 340-10-S99-1, the reporting entity should expense those legal fees in the period incurred because it is probable as of the balance sheet date that the fees would be expensed in the subsequent period.

If the reporting entity had not finalized its debt restructuring prior to issuing the financial statements and the reporting entity did not have enough information to determine if the transaction will be a modification or extinguishment in the subsequent period, the legal fees should be capitalized as a prepaid expense in the period incurred. However, we typically would not expect a long time lag between incurring such costs and the finalization of the debt restructuring since the costs must be directly related to the restructuring.

Once the debt restructuring is completed, the fees should be accounted for using the guidance in ASC 470-50-40. See Figure FG 3-4 for further information on the accounting treatment for fees.

#### **3.4.12 *Parent's involvement in a consolidated subsidiary's debt***

On a consolidated basis, the debt of a consolidated subsidiary represents debt of the parent. Therefore, if debt of a consolidated subsidiary is exchanged for debt of the parent company, the guidance in ASC 470-50-40 should be applied to determine whether the exchange should be accounted for as a modification or an extinguishment in the consolidated financial statements.

A parent company may also acquire the debt of a consolidated subsidiary for cash. When this occurs, the requirements for extinguishment accounting in the subsidiary's standalone financial statements are generally not met; however, on a consolidated basis, the consolidated entity has reacquired its own debt so extinguishment accounting is appropriate. See FG 3.7 for information on accounting for a debt extinguishment.

#### **3.4.13 *Delayed draw term loan***

When a loan modification or exchange transaction involves the addition of a delayed draw loan commitment with the same lender, we believe it would not be appropriate to include the unfunded commitment amount of delayed draw term loan in the 10% test since the commitment is not funded on the modification date. However, reporting entities should consider whether any fees paid in the restructuring should be allocated to the delayed draw commitment. If so, the fees should be accounted for based on the guidance in FG 1.2.4.

### 3.5 *Line of credit and revolving-debt arrangements*

A line of credit, or revolving-debt arrangement, is an agreement that provides the borrower with the ability to borrow money as needed (up to a specified maximum amount), repay portions of its previous borrowings, and reborrow under the same contract. Line of credit and revolving-debt arrangements may include both amounts drawn by the borrower (a debt instrument) and a commitment by the lender to make additional amounts available to the borrower under predefined terms (a loan commitment). Generally, a borrower incurs costs to establish a line of credit or revolving-debt arrangement; some or all of the costs are deferred and amortized over the term of the arrangement.

When a drawn line of credit or revolving-debt arrangement is modified, the borrower should first determine whether it is a troubled debt restructuring (TDR). See FG 3.3 for further information on TDRs.

If the modification is not a TDR, the borrower should apply the guidance in ASC 470-50-40-21 provided the lender before and after the modification is the same.

#### **Excerpt from ASC 470-50-40-21**

Modifications to or exchanges of line-of-credit or revolving-debt arrangements resulting in either a new line-of-credit or revolving-debt arrangement or resulting in a traditional term-debt arrangement shall be evaluated in the following manner:

- a. The debtor shall compare the product of the remaining term and the maximum available credit of the old arrangement (this product is referred to as the borrowing capacity) with the borrowing capacity of the new arrangement.
- b. If the borrowing capacity of the new arrangement is greater than or equal to the borrowing capacity of the old arrangement, then any unamortized deferred costs, any fees paid to the creditor, and any third-party costs incurred shall be associated with the new arrangement (that is, deferred and amortized over the term of the new arrangement).
- c. If the borrowing capacity of the new arrangement is less than the borrowing capacity of the old arrangement, then:
  1. Any fees paid to the creditor and any third-party costs incurred shall be associated with the new arrangement (that is, deferred and amortized over the term of the new arrangement).
  2. Any unamortized deferred costs relating to the old arrangement at the time of the change shall be written off in proportion to the decrease in borrowing capacity of the old arrangement. The remaining unamortized deferred costs relating to the old arrangement shall be deferred and amortized over the term of the new arrangement.

The assessment described in ASC 470-50-40-21 should be made on a lender by lender basis. If a lender exits the line of credit completely, then all unamortized costs associated with that lender should be expensed.

ASC 470-50-40-21, as amended by ASU 2021-04, requires that an increase or decrease in the fair value of a freestanding equity-classified written call option held by a creditor that is modified as part of a

modification of a line of credit or revolving debt arrangement held by the same creditor be accounted for the same as fees paid between a debtor or creditor.

An increase in the fair value of a freestanding equity-classified written call option held by a third party that is modified as part of a modification of a line of credit or revolving debt arrangements would be accounted for the same as any third-party costs.

Refer to FG 8.3 for further discussion on ASU 2021-04.

Example FG 3-6 illustrates the accounting treatment for unamortized costs and new fees in a modification of a revolving-debt arrangement.

### EXAMPLE FG 3-6

#### Accounting for unamortized costs and new fees in revolving-debt arrangements

FG Corp has a line of credit with a lender. FG Corp decides to modify the line of credit arrangement to extend the term and reduce the commitment amount.

The following table summarizes the terms of the original line of credit and the new line of credit on the modification date.

|                                 | Original line of credit | New line of credit |
|---------------------------------|-------------------------|--------------------|
| Original term                   | 5 years                 | 4 years            |
| Remaining term                  | 3 years                 | 4 years            |
| Commitment amount               | \$10,000,000            | \$5,000,000        |
| Unamortized debt issuance costs | \$200,000               | Not applicable     |
| New third party fees            | Not applicable          | \$10,000           |
| New lender fees                 | Not applicable          | \$20,000           |

The modification is not a TDR because FG Corp is not experiencing financial difficulties.

How should FG Corp account for the unamortized debt issuance costs related to the original line of credit and the new third-party and lender fees?

#### *Analysis*

To determine the accounting treatment for the unamortized debt issuance costs and new fees, the borrowing capacity of the original arrangement is compared to the borrowing capacity of the new arrangement. Borrowing capacity is calculated as the commitment amount multiplied by the remaining term of the arrangement.

**Borrowing capacity on original line of credit**

|                             |              |
|-----------------------------|--------------|
| Total commitment amount     | \$10,000,000 |
| Remaining term              | 3 years      |
| Original borrowing capacity | \$30,000,000 |

**Borrowing capacity on new line of credit**

|                         |              |
|-------------------------|--------------|
| Total commitment amount | \$5,000,000  |
| Remaining term          | 4 years      |
| New borrowing capacity  | \$20,000,000 |

The borrowing capacity decreased by \$10,000,000, or 33%. Therefore, 33% of the unamortized costs (\$66,000) should be expensed in the current period. The remaining unamortized debt issuance costs should be amortized over the term of the new arrangement.

The new lender fees and third-party fees should be capitalized and amortized over four years, which is the term of the new arrangement.

### 3.6 *Loan syndication and participation*

Many financing arrangements involve multiple lenders that are members of a loan syndicate or loan participation. The accounting for a modification of a loan syndication differs from that of a loan participation.

Figure FG 3-5 summarizes how to perform the 10% test for a loan syndication and loan participation.

**Figure FG 3-5**  
10% test for loan syndication and loan participation

|                        | <b>Loan syndication</b>  | <b>Loan participation</b>  |
|------------------------|--|--|
| Description            | Each lender has a separate loan with the borrower                                | The lead lender has a loan with the borrower; participating lenders have an interest represented by a certificate of participation |
| How to do the 10% test | The borrower performs the 10% test separately for each lender in the syndication | The borrower performs the 10% test for the entire loan with the lead lender  |

The accounting for each lender in a term loan syndicate can be different; one lender's loan may be considered modified, while another's may be considered extinguished. Similarly, under ASC 470-50-40-21, issuance costs may be written off for one member of a line-of-credit syndicate but not another.

As discussed in ASC 470-50-55-2, if an exchange or modification offer is made to all members of a loan syndicate and only some of the lenders agree to the offer, the 10% test should be applied to the debt instruments held by the lenders that accept the offer. Debt instruments held by lenders that do not agree to the exchange or modification offer are not affected unless they are paid off, in which case they are extinguished.

If a new lender enters a loan syndicate and provides a new term loan or access to a new line of credit, it is considered a new arrangement and not a modification. Therefore, fees paid to that lender and allocated third-party costs should be accounted for in the same way as for a new loan or line of credit (i.e., deferred as debt issuance costs and amortized over the life of the new term loan or line of credit).

The modification of a loan syndication will typically be arranged by an investment bank; oftentimes, that investment bank is also a lender in the loan syndication. A reporting entity should assess whether fees paid to the investment bank arranging the restructuring are being paid for third-party services or as a lender fee. If the investment bank is being compensated to perform services that could be performed by a third party, the fee should generally be accounted for as a third-party cost.

### Question FG 3-3

A reporting entity issues debt to a loan syndicate, which includes two funds managed by FG Group, FG Fund 1 and FG Fund 2. The reporting entity later replaces this debt with new debt issued to a loan syndicate which includes FG Fund 1 and FG Fund 5, which is also managed by FG Group.

Should the reporting entity treat the funds as one lender or separate lenders for purposes of determining whether its debt has been modified or extinguished?

#### ***PwC response***

It depends on how the funds are structured and managed. If FG Group's funds are effectively operated as separate funds, they should be treated as such in the analysis. Conversely, if the funds are effectively operated as one fund, they should be treated as a single lender. For example, if the FG Funds are (1) separate legal entities, (2) not consolidated by FG Group, and (3) FG Group has a fiduciary responsibility to manage each fund for the best interest of the holders of each particular fund, then each FG Group fund should be treated as a separate lender for purposes of determining whether its debt has been modified or extinguished. The debt held by FG Fund 2 should be extinguished because it is not participating in the new loan syndication. The debt issued to FG Fund 5 should be accounted for as new debt because it did not hold debt in the original syndicate. The debt held by FG Fund 1 should be assessed under the guidance in ASC 470-50-40 to determine whether the transaction should be accounted for as a modification or an extinguishment.

#### **3.6.1 Cost allocation for multiple instruments with multiple lenders**

In practice, a reporting entity may modify non-revolving (i.e., term debt) and revolving-debt arrangements at the same time. When this occurs, the reporting entity should allocate the new lender fees and third-party costs to the individual instruments using a reasonable and rational approach. These new fees and costs should be first allocated to each instrument; then further allocated to each lender. Once this allocation is complete, the reporting entity should determine (1) whether the non-revolving debt has been modified or extinguished under the guidance in ASC 470-50-40, and (2) the appropriate accounting for the revolving-debt arrangement under the guidance in ASC 470-50-40-21.

**Question FG 3-4**

A reporting entity has a \$5,000,000 term loan that is prepayable without penalty. Two years prior to the maturity of the term loan, the reporting entity repays the term loan and concurrently enters into a revolving-debt arrangement with the same lender. The revolving-debt arrangement has a maximum amount available of \$5,000,000 for five years. The reporting entity immediately draws \$5,000,000 on the revolving-debt arrangement.

How should the reporting entity determine whether the term loan has been modified or extinguished for accounting purposes?

***PwC response***

Although there is no guidance on how to account for a term loan that is replaced with a revolving-debt arrangement, ASC 470-50-55-10 through ASC 470-50-55-13 discusses the accounting for a modification of a revolving-debt arrangement with a term loan. This guidance respects the initial form of the debt instrument and states that a modification of a revolving-debt arrangement with a term loan should be assessed under the revolving debt guidance in ASC 470-50-40-21. We believe it is appropriate to analogize to that guidance and respect the initial form of the debt instrument. Therefore, when a term loan is replaced with a revolving-debt arrangement, we believe the 10% test should be used to determine whether a term loan has been modified or extinguished for accounting purposes given the terms of the amount borrowed under the new revolving-debt arrangement.

Example FG 3-7 illustrates the accounting for a modification of a term loan syndication.

**EXAMPLE FG 3-7****Modification of a term loan syndication**

FG Corp has a term loan syndication. Its credit rating has improved, and interest rates have declined since the original loan syndication was entered into, so FG Corp has decided to modify its loan syndication to lower its borrowing costs.

The existing loans in the loan syndication are prepayable at any time without penalty; therefore, the fees paid by FG Corp are related to the borrowing of additional funds. The terms of the original loan syndication and the new loan syndication at the modification date are summarized in the following table.

|                                 | <b>Original loan syndication</b> | <b>New loan syndication</b> |
|---------------------------------|----------------------------------|-----------------------------|
| Principal balance               | \$52,000,000                     | \$100,000,000               |
| Annual coupon                   | 5.5%                             | 5.0%                        |
| Original term                   | 10 years                         | 5 years                     |
| Remaining term                  | 3 years                          | 5 years                     |
| Unamortized debt issuance costs | \$695,000                        | —                           |



|                      | <b>Original loan<br/>syndication</b> | <b>New loan<br/>syndication</b> |
|----------------------|--------------------------------------|---------------------------------|
| New lender fees      | —                                    | \$4,000,000                     |
| New third-party fees | —                                    | \$1,000,000                     |

The modification is not a TDR because FG Corp is not experiencing financial difficulties.

How should FG Corp account for the restructuring of its term loan syndication?

### *Analysis*

FG Corp should perform the following analysis.

### *Compare lender balances*

Lenders in the original and new loan syndications are compared to determine common lenders to both agreements. The principal balances of common lenders are classified as (1) original debt, (2) additional borrowing, or (3) pay-down.

The lender by lender balances in the original and new loan syndications, the change in each lender's balance, and the classification of each lender's principal balance are summarized in the following table.

| <b>Bank</b> | <b>Balance of<br/>original<br/>syndication</b> | <b>Balance of new<br/>syndication</b> | <b>Principal<br/>change</b> | <b>Classification</b>                     |
|-------------|--|---------------------------------------|-----------------------------|---|
| A           | \$5,000,000                                    | \$5,000,000                           | —                           | Original debt                             |
| B           | \$20,000,000                                   | \$30,000,000                          | \$10,000,000                | Original debt and<br>additional borrowing |
| C           | —  | \$60,000,000                          | \$60,000,000                | Additional borrowing                      |
| D           | \$12,000,000                                   | \$5,000,000                           | (\$7,000,000)               | Original debt and<br>partial pay-down     |
| E           | \$15,000,000                                   | —                                     | (\$15,000,000)              | Full pay-down                             |
| Total       | \$52,000,000                                   | \$100,000,000                         |                             |   |

### *Allocate new lender fees to each lender*

Next, the new lender fees paid are allocated to each lender in the syndicate. New fees paid to lenders are allocated to each bank in the new syndicated facility using a rational approach, which is determined to be pro-rata in this fact pattern. Because all of the loans are prepayable without penalty, none of the fees paid are associated with the pay-off amounts.

| Bank         | Balance of new syndication | Percentage of new syndication | Allocation of new lender fees |
|--------------|----------------------------|-------------------------------|-------------------------------|
| A            | \$5,000,000                | 5.0%                          | \$200,000                     |
| B            | \$30,000,000               | 30.0%                         | \$1,200,000                   |
| C            | \$60,000,000               | 60.0%                         | \$2,400,000                   |
| D            | \$5,000,000                | 5.0%                          | \$200,000                     |
| E            | —                          | —                             | —                             |
| <b>Total</b> | <b>\$100,000,000</b>       | <b>100.00%</b>                | <b>\$4,000,000</b>            |

### *Perform the 10% test*

Using the information in the two tables above, FG Corp would perform the 10% test for the lenders that were in the facility before and after the restructuring; the results of the 10% test are summarized in the table below.

The new loan syndication is prepayable at any time without penalty; therefore, to determine the cash flows of the new loan syndication, FG Corp would assume prepayment at the modification date and calculate the new loan syndication cash flows as the sum of (1) the change in principal balance, (2) the new lender fees, and (3) the repayment of the “new” principal (i.e., assume the principal balance post modification is pre-paid).

See FG 3.4.5 for further information on changes in principal balance.

| Bank | New cash flow detail |                  |               |                |                | Total new cash flows | Percent change |
|------|----------------------|------------------|---------------|----------------|----------------|----------------------|----------------|
|      | Original cash flows  | Principal change | Lender fees   | Repayment      |                |                      |                |
| A    | (\$5,000,000)        | —                | (\$200,000)   | (\$5,000,000)  | (\$5,200,000)  | (4%)                 |                |
| B    | (\$20,000,000)       | \$10,000,000     | (\$1,200,000) | (\$30,000,000) | (\$21,200,000) | (6%)                 |                |
| D    | (\$12,000,000)       | (\$7,000,000)    | (\$200,000)   | (\$5,000,000)  | (\$12,200,000) | (2%)                 |                |

Because each change in cash flows is less than 10%, it is not necessary to perform the cash flow scenarios assuming no prepayment. The change in each lender’s loan balance should be accounted for as a modification.

### *Account for unamortized costs*

Unamortized debt issuances costs from the original syndicated facility are allocated to each bank on a pro-rata basis using the original syndication balances. The unamortized debt issuance costs associated with loans that are paid in full are expensed. The remaining unamortized debt issuance costs continue to be deferred.

The following table summarizes the allocation of unamortized issuance costs.

| <b>Bank</b>  | <b>Balance of original syndication</b> | <b>Percentage of original syndication</b> | <b>Allocation of unamortized issuance costs</b> | <b>Accounting for unamortized issuance costs</b> |
|--------------|--|---|---|--|
| A            | \$5,000,000                            | 9.6%                                      | \$66,827  | Defer  |
| B            | \$20,000,000                           | 38.5%                                     | \$267,308                                       | Defer  |
| D            | \$12,000,000                           | 23.1%                                     | \$160,385                                       | Defer  |
| E            | \$15,000,000                           | 28.8%                                     | \$200,480                                       | Expense  |
| <b>Total</b> | <b>\$52,000,000</b>                    | <b>100.0%</b>                             | <b>\$695,000</b>                                |  |

*The amounts allocated to the loans that are fully paid off are written off pursuant to ASC 470-50-40-2. The amounts allocated to the original debt that remains outstanding continue to be deferred because the loans were modified for accounting purposes, rather than extinguished.*

#### *Account for lender fees*

As noted above, new fees paid to lenders were allocated to each bank in the new syndicated facility on a pro-rata basis and all of the fees paid are associated with either the remaining original debt or the additional borrowings. No amounts were allocated to the loans paid off. Therefore, all of the lender fees are capitalized in accordance with ASC 470-50-40-17 for the original loan and ASC 835-30-45-1A for the additional borrowings.

#### *Account for third-party costs*

New fees paid to third parties are allocated to each bank in the new syndicated facility using a rational approach. The third-party fees allocated to the new borrowing with Bank C should be deferred in accordance with ASC 835-30-45-3. The remaining third-party costs should be expensed in accordance with ASC 470-50-40-18.

The following table summarizes the allocation of the third-party fees.

| <b>Bank</b>  | <b>Balance of new syndication</b> | <b>Percentage of new syndication</b> | <b>Allocation of new third-party fees</b> | <b>Accounting for new third-party fees</b> |
|--------------|-----------------------------------|--------------------------------------|---|--|
| A            | \$5,000,000                       | 5.0%                                 | \$50,000                                  | Expense                                    |
| B            | \$30,000,000                      | 30.0%                                | \$300,000                                 | Expense                                    |
| C            | \$60,000,000                      | 60.0%                                | \$600,000                                 | Defer                                      |
| D            | \$5,000,000                       | 5.0%                                 | \$50,000                                  | Expense                                    |
| E            | —                                 | —                                    | —   |  |
| <b>Total</b> | <b>\$100,000,000</b>              | <b>100.00%</b>                       | <b>\$1,000,000</b>                        |  |

### 3.7 Debt extinguishment accounting

ASC 405-20-40-1 provides guidance on when a reporting entity should derecognize a liability. This guidance does not apply to convertible debt with a cash conversion feature. See FG 6.5.1 (post adoption of ASU 2020-06) and FG 6.6.5A (pre adoption of ASU 2020-06) for information on the derecognition (conversion or extinguishment) of such instruments.

#### **Excerpt from ASC 405-20-40-1**

Unless addressed by other guidance (for example, paragraphs 405-20-40-3 through 40-4 or paragraphs 606-10-55-46 through 55-49), a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
  1. Delivery of cash
  2. Delivery of other financial assets
  3. Delivery of goods or services
  4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

A reporting entity should also derecognize a debt instrument (and recognize a new one) when a debt modification or exchange is deemed an extinguishment. See FG 3.4 for information on modifications and exchanges of term loans and debt securities, and FG 3.6 for information on modifications and exchanges of loan syndications and participations.

ASC 470-50-55-9 provides guidance on situations that do not result in a debt extinguishment.

#### **ASC 470-50-55-9**

The following situations do not result in an extinguishment and would not result in gain or loss recognition under either paragraph 405-20-40-1 or this Subtopic:

- a. An announcement of intent by the debtor to call a debt instrument at the first call date
- b. In-substance defeasance
- c. An agreement with a creditor that a debt instrument issued by the debtor and held by a different party will be redeemed.

An extinguishment should not be recognized prior to its occurrence; therefore, a debtor's announcement of its intent to call its debt should not result in an extinguishment.

See FG 3.8 for information on debt defeasance.

### 3.7.1 *Measuring the gain or loss on debt extinguishment*

ASC 470-50-40-2 provides guidance on how to calculate a gain or loss on debt extinguishment.

#### **ASC 470-50-40-2**

A difference between the reacquisition price of the debt and the net carrying amount of the extinguished debt shall be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. Gains and losses shall not be amortized to future periods. If upon extinguishment of debt the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges shall be given appropriate accounting recognition. Moreover, extinguishment transactions between related entities may be in essence capital transactions.

The ASC Master Glossary defines the reacquisition price of debt and the net carrying amount of debt.

#### **Definitions from ASC Master Glossary**

**Reacquisition Price of Debt:** The amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities.

**Net Carrying Amount of Debt:** Net carrying amount of debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.

The reacquisition price includes the fair value of any assets transferred or equity securities issued. It also includes fees (which may include noncash fees) the reporting entity pays the original lender in connection with the extinguishment. Typically, accrued interest payable is settled in cash upon extinguishment (i.e., the issuer pays the investor the accrued interest in cash). However, if accrued interest payable is not paid in cash upon extinguishment, it should be deducted from the reacquisition price (i.e., a portion of the reacquisition price should be treated as payment of interest). The net carrying amount of debt includes an unamortized premium, discount, and debt issuance costs.

If a reporting entity extinguishes a portion of a debt instrument (e.g., exercises an existing prepayment option) and all future principal payments are reduced pro-rata by the percentage of debt paid down, the unamortized premium, discount, and debt issuance costs associated with the portion extinguished should be expensed; the remaining unamortized debt issuance costs should continue to be deferred. There would be no change to the effective interest rate of the remaining debt. For example, if a reporting entity exercises an existing call option and repays 50% of the debt balance and all future principal payments of the debt are reduced by 50%, the reporting entity has extinguished 50% of the debt and should expense 50% of the unamortized costs.

However, there are situations when an entity exercises an existing call option and repays a portion of the debt balance but all of the future principal payments are not reduced pro-rata. For example, the prepayment may reduce the principal amount due at final maturity while the principal payments prior to maturity are not reduced at all. In these instances, an entity must update the effective interest rate because the amount and timing of future cash flows has changed since the effective interest rate was established. When the amount and timing of future cash flows change, one of the following methods should be applied:

- Prospective approach: A new effective interest rate is computed based on the current carrying value of the debt and the revised estimated remaining cash flows. Changes in cash flows from previous estimates are included in future interest expense on a prospective basis.
- Catch-up approach: The carrying value of the debt is adjusted to the present value of the revised estimated cash flows discounted at the original effective interest rate. Using this approach, the impact of the change in cash flows is recorded in the current period.
- Retrospective approach: A new effective interest rate is computed based on the original proceeds received, actual cash flows to date, and the revised estimate of remaining cash flows. The new effective interest rate is then used to adjust the carrying value of the debt to the present value of the revised estimated cash flows, discounted at the new effective interest rate. Using this approach, the impact of the change in cash flows is recorded in the current and future periods.

While a current period adjustment is recorded under both the catch-up and retrospective approaches, the key distinction relates to the effective interest rate. In a catch-up approach, cash flows are updated to reflect current estimates, but the rate used to discount those cash flows remains the original effective interest rate. Under the retrospective approach, the effective interest rate is changed to reflect the actual cash flows paid to date and the revised estimate of future cash flows. This change to the effective interest rate should be made on the date of the partial extinguishment and used for the remainder of the life of the debt instrument (unless another modification or extinguishment occurs). An entity should establish an accounting policy as to which method it utilizes and apply that method consistently.

See FG 3.3.5 for information on the recognition of a debt extinguishment gain when a lender also holds equity securities of the reporting entity. Extinguishment losses are typically charged to earnings unless the loss is in substance a dividend (i.e., a pro-rata distribution to all equity holders).

See FSP 12.11.1 for information on the classification of a gain or loss on debt extinguishment.

Example FG 3-8 illustrates how the gain or loss on a debt extinguishment is measured.

### **EXAMPLE FG 3-8**

#### **Calculating a gain or loss on debt extinguishment**

FG Corp reacquired its term loan for cash of \$50,000,000. It paid \$500,000 in fees to its original lender in connection with the extinguishment.

The carrying amount of the debt at the date of reacquisition was \$50,000,000, and FG Corp had unamortized debt issuance costs of \$1,000,000. There is no unamortized debt discount or premium and no accrued interest payable associated with the debt.

What is FG Corp's gain or loss on extinguishment of its debt?

#### *Analysis*

The reacquisition price is the carrying amount of the debt and the fees paid to the lender to extinguish the debt.

The gain or loss on extinguishment is calculated as follows:

|                                       |              |
|---------------------------------------|--------------|
| Term loan carrying amount             | \$50,000,000 |
| Less: unamortized debt issuance costs | (1,000,000)  |
| Net carrying amount                   | 49,000,000   |
| Reacquisition price                   | 50,500,000   |
| Loss on extinguishment                | \$1,500,000  |

FG Corp should recognize a loss on extinguishment of \$1,500,000 in net income.

### **3.7.2** *Debt extinguishment as a subsequent event*

An extinguishment occurring subsequent to the end of a fiscal period but prior to the issuance of the financial statements should be accounted for as a nonrecognized subsequent event, which is not recorded in the financial statements, but may require disclosure. See FSP 28 for information on subsequent events.

## **3.8** *Debt defeasance*

A borrower may enter into a defeasance, or refunding, arrangement with its lenders in an effort to derecognize its debt liability. A defeasance arrangement is generally a legal defeasance of the borrower's liability to the lender, not a payment by the borrower to the lender. Defeasance arrangements may involve the borrower transferring an amount of cash or high-quality financial assets sufficient to service the debt obligation to maturity (or to an earlier call date) to an irrevocable trust. The trust undertakes the obligation to service the debt using the assets it has received.

To determine the appropriate accounting for a debt defeasance, a debtor should consider whether it has been legally released from being the primary obligor under the liability based on the guidance in ASC 405. If the arrangement involves the transfer of assets to a trust, it should determine whether it has surrendered control over the transferred financial assets based on the guidance in ASC 860-10-40-4 through ASC 860-10-40-6 and if it should consolidate the trust for financial reporting purposes (see CG 2 for information on consolidation of a trust).

When a lender releases a debtor as the primary obligor, it may require the debtor to become the secondary obligor (i.e., the debtor becomes a guarantor). Depending on the facts and circumstances, such an obligation could prevent derecognition of the liability. See FG 2 for information on the accounting for guarantees.

### 3.8.1 *Legal defeasance versus in-substance defeasance*

ASC 405-20-55-9 provides guidance on when a liability is extinguished by a debt defeasance.

#### **ASC 405-20-55-9**

In a legal defeasance, generally the creditor legally releases the debtor from being the primary obligor under the liability. Liabilities are extinguished by legal defeasances if the condition in paragraph 405-20-40-1(b) is satisfied. Whether the debtor has in fact been released and the condition in that paragraph has been met is a matter of law. Conversely, in an in-substance defeasance, the debtor is not released from the debt by putting assets in the trust. For the reasons identified in paragraph 405-20-55-4, an in-substance defeasance is different from a legal defeasance and the liability is not extinguished.

Whether a borrower has met the requirements for legal defeasance and consequently satisfied the condition for extinguishment accounting in ASC 405-20-40-1(b) is a matter of law. The best form of evidence to provide reasonable assurance that criterion ASC 405-20-40-1(b) has been satisfied is a legal opinion.

In an in-substance defeasance, the debtor transfers cash or high-credit quality assets to an irrevocable trust established for the benefit of the lender. The cash flows from the assets are used to pay the scheduled interest and principal payments on the debt; however, the lender does not release the debtor as the primary obligor for the debt. ASC 405-20-55-3 to ASC 405-20-55-4 provide guidance on an in-substance defeasance.

#### **ASC 405-20-55-3**

In an in-substance defeasance transaction, a debtor transfers essentially risk-free assets to an irrevocable defeasance trust and the cash flows from those assets approximate the scheduled interest and principal payments of the debt being extinguished.

#### **ASC 405-20-55-4**

An in-substance defeasance transaction does not meet the derecognition criteria in either Section 405-20-40 for the liability or in Section 860-10-40 for the asset. The transaction does not meet the criteria because of the following:

- a. The debtor is not released from the debt by putting assets in the trust; if the assets in the trust prove insufficient, for example, because a default by the debtor accelerates its debt, the debtor must make up the difference.
- b. The lender is not limited to the cash flows from the assets in trust.
- c. The lender does not have the ability to dispose of the assets at will or to terminate the trust.
- d. If the assets in the trust exceed what is necessary to meet scheduled principal and interest payments, the transferor can remove the assets.
- e. Subparagraph superseded by Accounting Standards Update No. 2012-04



- f. The debtor does not surrender control of the benefits of the assets because those assets are still being used for the debtor's benefit, to extinguish its debt, and because no asset can be an asset of more than one entity, those benefits must still be the debtor's assets.

### **3.8.2 *Transfer of non-cash financial assets to a defeasance trust***

When a debtor transfers non-cash financial assets (i.e., treasury or other governmental securities) to a defeasance trust, it should evaluate the criteria in ASC 860-10-40-4 through ASC 860-10-40-6 to determine whether it has surrendered control over the transferred assets. Under that guidance, the transferred assets must be legally isolated from the debtor (e.g., put presumptively beyond the reach of the debtor and its lenders, even in bankruptcy or other receivership), the debtor must surrender control over the transferred assets, and the trust must obtain control of the assets in order for them to be derecognized. The isolation criterion is primarily a legal determination; a legal opinion is needed to evaluate satisfaction of this criterion. See TS 3 for information on control criteria for transfers of financial assets.

If any of the criteria in ASC 860-10-40-4 through ASC 860-10-40-6 are not met, the debtor should not derecognize the transferred financial assets or the debt. Additionally, the debtor should evaluate whether it is required to consolidate the trust.

### **3.8.3 *Transfer of cash to a defeasance trust***

In conjunction with a defeasance arrangement, a debtor may transfer cash to a defeasance trust so that the trust can purchase risk-free investments (i.e., treasury or other governmental securities) to provide cash flows corresponding to the debt service requirements. A transfer of cash is not within the scope of ASC 860-10-40-4 through ASC 860-10-40-6. Nevertheless, the debtor should evaluate its continuing involvement with the trust (or its assets) to determine whether it has relinquished control over the assets in the trust. If the debtor has control of the trust or its assets, it may raise the question of whether the trust's assets would be drawn into the debtor's bankruptcy proceeding. A legal opinion similar in form to an evaluation under ASC 860-10-40-4 through ASC 860-10-40-5 may be required to conclude that the transferred cash has been put presumptively beyond the reach of the debtor and its lenders, even in bankruptcy.

The form and extent of the continuing involvement is a matter of judgment that depends on the relevant facts and circumstances. The indicators listed below should be considered in that evaluation; however, no one indicator should be considered presumptive or determinative. The relative consequence of each indicator or combination of indicators should be considered.

- The debtor maintains a residual interest in the assets of the trust
- The debtor may instruct the trustee to sell trust assets and purchase other assets
- The trust may seek investment advice from the debtor
- The trustee may apply at any time to the debtor for instructions, and may consult with counsel for the debtor as to matters arising in connection with its servicing of the trust
- The debtor is a secondary obligor to the liability assumed by the trust

If the debtor has a significant level of continuing involvement, and is not able to obtain a legal opinion concluding that the transferred cash has been put presumptively beyond the reach of the debtor and its lenders, even in bankruptcy, the debt should not be extinguished. Additionally, the level of continuing involvement may cause the debtor to have to consolidate the trust for financial reporting purposes.

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***Chapter 4:  
Common stock and  
dividends—updated  
December 2021***

## 4.1 Overview of common stock issuance and dividends

This chapter discusses the accounting considerations related to the issuance of common stock and other transactions with shareholders, such as advances to shareholders. It also discusses the accounting treatment of dividends and stock splits.

See FG 7 for information on preferred stock and the accounting for equity issuance costs. See FG 9 for information on share repurchases and treasury stock.

## 4.2 Characteristics of common stock

Common stock is the most subordinate class of shares of a reporting entity. The common shareholders generally profit the most when a reporting entity is successful and bear the greatest risk of loss when a reporting entity fails. Figure 4-1 summarizes some of the characteristics of common stock.

**Figure FG 4-1**

Characteristics of common stock

| Feature                | Overview  |
|------------------------|---|
| Liquidation preference | In the event of liquidation, common shareholders have an unsecured interest over the reporting entity's residual net assets after satisfaction of all other claims and preferences and bear the ultimate risk of loss |
| Dividends              | Dividends paid to common shareholders may vary from period to period and typically are not guaranteed   |
| Voting                 | Typically, common shareholders control the voting power of a reporting entity   |
| Term                   | Common stock typically has no redemption date   |
| Par value              | Most common stock has either no or minimal par value  |

In every corporation, one class of stock represents the basic ownership interest; that class is called common stock. However, in an effort to broaden investor appeal, corporations may offer two or more classes of common stock, each with different rights or privileges. Common stock can be issued in a variety of ways, including through an original capital infusion, an initial public offering, issuance of stock-based compensation, settlement of equity-linked instruments, and stock dividends.

## 4.3 Accounting for the issuance of common stock—updated December 2021

Common stock should be recognized on its settlement date (i.e., the date the proceeds are received and the shares are issued). Upon issuance, common stock is generally recorded at its fair value, which is typically the amount of proceeds received. Those proceeds are allocated first to the par value of the shares (if any), with any excess over par value allocated to additional paid-in capital.

If common stock is sold using an escrow arrangement in which cash is deposited in an escrow account for the purchase of the shares, the issuer should determine who owns the escrow account in the event of the investor's bankruptcy. If the investor's creditors have access to the escrowed cash in the event of the investor's bankruptcy, the cash held in escrow should not be recorded on the issuer's balance sheet and the common stock should not be recorded until the escrowed cash is legally transferred to the issuer and the shares are delivered to the investor.

In some cases, a legally issued and outstanding share of common stock may be accounted for as a contract to issue shares (e.g., if the shares are contingently returnable (subject to recall)) rather than an outstanding share for accounting purposes. This determination requires an understanding of the legal arrangement and is subject to significant judgment. See FG 5.1 for additional information, including an example.

Common stock may be sold for future delivery through a forward sale contract. In a forward sale contract, the investor is obligated to buy (and the reporting entity is obligated to sell) a specified number of the reporting entity's shares at a specified date and price. See FG 8.2.1 for information on forward sales of a reporting entity's own equity securities.

When common stock is sold in a bundled transaction with other securities or instruments, such as preferred stock or warrants, the proceeds should be allocated between the common stock and other instruments issued. How the proceeds are allocated depends on the accounting classification (i.e., liability or equity) of the other instruments. See FG 8.4.1 for information on warrants issued with common stock.

If separate classes of securities, which each meet the requirements for equity classification (such as preferred or common stock), are issued together in a single transaction, the issuance proceeds should be allocated to each class based upon their relative fair values. The fair value of each class of equity securities may be different than the amounts stipulated in the purchase agreement. When multiple investors are involved, the allocation of proceeds should be performed on an investor-by-investor basis.

When a reporting entity receives a note rather than cash or other assets in exchange for issuing common stock, the note should generally be classified as a contra-equity account, which offsets the increase in equity from the issuance of the shares. See FG 4.5.1 for additional information.

#### **4.3.1 *Estimating the fair value of common stock***

When common shares are not traded (or, in the case of bundled issuances of common and preferred shares, are not traded separately) in an active market, it can be difficult to determine their fair value. Nevertheless, US GAAP provides no relief from the requirement to determine fair value in those circumstances. When estimating the fair value of common stock, an issuer should follow the guidance in ASC 820, *Fair Value Measurement*. See FV 4 for information on determining the fair value of equity securities.

In addition, a reporting entity should consider the SEC staff's views on "cheap stock." Cheap stock broadly refers to equity instruments, such as common stock, stock options, or equity classified warrants, that are issued shortly before an initial public offering date, at prices significantly below the initial public offering price. See SC 6.6 for further information.

### **4.3.2 Market value guarantee of common stock**

A reporting entity may enter into an arrangement with a shareholder under which it guarantees a minimum price for its common stock. Such a guarantee protects the shareholder from declines in the value of the reporting entity's common stock. The terms of the guarantee may require the reporting entity to repurchase the shares from the shareholder in exchange for cash (i.e., the shares become puttable) or may require the shareholder to sell the shares in the open market and have the reporting entity pay the difference between the sales price and the guaranteed price.

When a market value guarantee is embedded in the common shares (i.e., the shares can be put to the reporting entity) the shares should be recorded in mezzanine equity. See FG 7.3.4 for further information on mezzanine equity classification. If instead, a market value guarantee requires the shareholder to sell its shares in the open market and the reporting entity pays the difference between the sales price and the guaranteed price, the market value guarantee may be a written put option which should be recorded as a liability based on the guidance in ASC 480, *Distinguishing Liabilities from Equity*. See FG 9.2.5 for information on written put options on a reporting entity's own shares.

### **4.3.3 Common stock issuance costs**

Common stock issuance costs are incremental costs directly associated with issuance. These costs typically include fees paid to bankers or underwriters, attorneys, accountants, as well as printers and other third parties. As discussed in ASC 340-10-S99-1 (SAB Topic 5.A), certain period costs such as management salaries or other general and administrative expenses are not considered costs of issuance. Common stock issuance costs are generally recorded as a reduction of the share proceeds.

The SEC staff stated in ASC 340-10-S99-1 (SAB Topic 5.A) that prior to the effective date of an offering of equity securities, specific incremental costs directly attributable to a proposed or actual offering of securities may be deferred and charged against the gross proceeds of the offering. However, deferred costs related to an aborted offering (including an offering with postponement for more than 90 days) may not be deferred and charged against proceeds of a subsequent offering.

### **4.3.4 Modifications or exchanges of common stock**

Although less common than modifications or exchanges of preferred stock, a reporting entity may modify or exchange its common stock, often in conjunction with a broader recapitalization of the reporting entity. There is no specific guidance related to a modification or exchange of common stock; therefore, the appropriate accounting treatment requires judgment and a careful evaluation of the facts and circumstances. Often, there is no accounting required for a modification or exchange of common stock. In situations when the modification results in a value transfer from the common shareholders to the preferred shareholders, it may be considered a deemed dividend to the preferred shareholders.

In situations when the modification or exchange results in a value transfer to a second class of common stockholder, the reporting entity should consider whether the value transfer should be considered in applying the two-class method of EPS.

## 4.4 Dividends

A dividend is a payment, either in cash, other assets (in kind), or stock, from a reporting entity to its shareholders. Figure FG 4-2 provides definitions for some of the terms used in connections with dividends.

**Figure FG 4-2**  
Terms used in connection with dividends

| <b>Term</b>                      | <b>Definition</b>   |
|----------------------------------|---|
| Consent dividend                 | Retained earnings of a personal holding company, which, although not distributed to shareholders, are reported by the shareholders for federal income tax purposes as an ordinary dividend. The tax basis of the stock is increased by the amount of the consent dividend   |
| Constructive dividend            | Distribution to shareholders without a formal dividend declaration by the board of directors  |
| Cumulative dividend              | Preferred dividend that must be declared and paid for all periods, before any dividend may be declared and paid to common shareholders  |
| Deemed dividend                  | A transaction that does not necessarily have the characteristics generally associated with a dividend, but nevertheless results in a transfer of value to the holder of an equity instrument that requires accounting similar to a dividend (e.g., accretion to redemption value on redeemable convertible preferred stock) |
| Dividend arrearage               | Cumulative preferred dividends for prior periods not declared or paid   |
| Dividend equivalents             | Amounts paid to holders of unissued shares (e.g., unvested stock or options) in a stock compensation plan   |
| Dividend in kind                 | Dividend paid by distributing property (including notes) of the reporting entity rather than cash   |
| Ex-dividend                      | Term indicating that the quoted price of a share of stock excludes the value of a declared dividend; the term attaches from the record date, or a few days before the record date (to allow for the recording of transfers just prior to the record date), until the payment date   |
| Extraordinary (special) dividend | Dividend in addition to the usual periodic dividend   |
| Liquidating dividend             | Distribution to shareholders in excess of earnings, representing a return of capital  |
| Nimble dividend                  | Dividend declared from current year earnings despite an accumulated deficit from past operations  |

| <b>Term</b>                 | <b>Definition</b>   |
|-----------------------------|---|
| Noncumulative dividend      | Preferred dividend to which the preferred shareholders lose their rights if the dividend is not declared in respect of the applicable period  |
| Nonparticipating dividend   | Preferred dividend that never exceeds a specified rate regardless of the dividends paid to common shareholders  |
| Optional dividend           | A dividend for which shareholders may choose to receive cash or shares  |
| Ordinary dividend           | Pro rata distribution to shareholders of cash, other assets (including evidences of indebtedness), or shares of capital stock declared by the board of directors  |
| Paid-in-kind (PIK) dividend | Dividend paid in the form of additional shares of stock having a value equal to the specified dividend rate   |
| Participating dividend      | Preferred dividend in excess of a stipulated minimum rate, shared with the common shareholders (the preferred shareholders participate in the earnings of the entity) usually after the dividends paid to the common shareholders reach a prescribed amount per share. Fully participating dividends are shared, after the prescribed minimums, without limitation; partially participating dividends are shared only to a specified maximum amount per share |
| Preferred dividend          | Dividend on preferred stock usually at a specified rate stated in dollars per share or as a percentage of par value, payable at stated intervals, usually quarterly   |
| Record date                 | Date at which shareholders registered in the stock records will share in the dividend payment. This date is usually between the declaration date and payment date   |
| Scrip dividend              | A dividend paid in the form of promissory notes that may be negotiable, bear interest, and mature at different dates, and that is usually payable in cash   |
| Spinoff                     | Pro rata distribution by a reporting entity of shares of a subsidiary without the surrender of the shares in the distributing reporting entity  |
| Split-off                   | Distribution by a reporting entity of shares of a subsidiary in exchange for a portion of the shares in the distributing reporting entity   |
| Splitup                     | Distribution by a reporting entity of shares of a subsidiary and new shares of its own stock in exchange for all of the old shares of the distributing reporting entity   |
| Stock dividend              | Dividend payable in shares of the reporting entity's own stock  |



| <b>Term</b> | <b>Definition</b>   |
|-------------|---|
| Stock split | Issuance of additional shares of stock at a fixed ratio in relation to current shares to present shareholders. See FG 4.4.4 for information on the distinction between stock dividends and stock splits |
| Record date | Date at which shareholders registered in the stock records will share in the dividend payment. This date is usually between the declaration date and payment date                                       |

See BCG 7, CO 1.3.2, and CO 1.3.3 for information on accounting for spinoff and split-off.

#### **4.4.1 Declaring a dividend**

Generally, a reporting entity's board of directors decides when, in what amount, and in what form of consideration dividends are to be paid. When making decisions about a dividend payment, the board considers a number of factors, including the following.

- The legality of the dividend in relation to the reporting entity's articles of incorporation and relevant state (or other jurisdiction) law
- Regulatory restrictions regarding dividend payments
- The reporting entity's financial position, including current and retained earnings and liquidity
- Future plans of the reporting entity
- Tax consequences
- General business conditions
- Long-term dividend policy, including planned return to the shareholders

Statutory restrictions may limit the timing and amount of dividends that can be declared to shareholders. Typically, a reporting entity is subject to the laws of the state in which it is incorporated. The diversity of dividend statutes across jurisdictions makes it impracticable to state a general rule on the amounts available for dividends. However, a common restriction is that dividends may not be paid if doing so would render the reporting entity insolvent. For solvent reporting entities, payment of dividends from retained earnings is almost always permissible. In the US, state law typically governs corporate activities, including the payment of dividends. Some states allow dividends to be paid from current earnings despite an accumulated deficit from past operations; these are sometimes referred to as nimble dividends. In some circumstances, dividends may be paid from capital surplus or an appraisal surplus. Outside the US, dividend restrictions may be more onerous and, in many cases, may also require shareholder approval before they can be declared and paid.

#### **4.4.2 Recording a dividend**

A dividend should be recorded when it is declared and notice has been given to the shareholders, regardless of the date of record or date of settlement. As a practical matter, the dividend amount is not

determinable until the record date. To record a dividend, a reporting entity should debit retained earnings (or any other appropriate capital account from which the dividend will be paid) and credit dividends payable on the declaration date.

#### **4.4.3 Dividend in kind**

A dividend in kind is paid by distributing property of the reporting entity, so is considered a nonmonetary transaction. As such, it should be recorded using the guidance in ASC 845, *Nonmonetary Transactions*. As discussed in ASC 845-10-30-10, when a reporting entity distributes its property (other than in a spinoff transaction) in a pro rata dividend to all shareholders, the amount of the dividend should be recorded at the fair value of the property distributed. On the declaration date, a reporting entity would record a dividend payable for the fair value of the assets. A gain or loss should be recognized for the difference between the fair value and carrying value of the property distributed on the date of disposition of the asset and settlement of the liability, as described in ASC 845-10-30-1.

If a reporting entity distributes shares of a consolidated entity or equity method investee as a dividend, it should be valued based on the recorded amount of the nonmonetary assets distributed based on the guidance in ASC 845-10-30-10.

#### **ASC 845-10-30-10**

Accounting for the distribution of nonmonetary assets to owners of an entity in a spinoff or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination shall be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) (see paragraph 360-10-40-4) of the nonmonetary assets distributed... A pro rata distribution to owners of an entity of shares of a subsidiary or other investee entity that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spinoff. Other nonreciprocal transfers of nonmonetary assets to owners shall be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

If part of the shares of an investee accounted for under the equity method are distributed as a dividend in kind and part are concurrently sold by the investor on the open market, accounting for the dividend in kind at the recorded amount may not be appropriate.

#### **4.4.4 Stock dividends and stock splits**

A stock dividend is a dividend paid in shares, generally issued to provide common shareholders with a portion of their respective interest in retained earnings without distributing cash from the business. A stock split is the issuance of common shares to existing shareholders for the purpose of reducing the per share market price. Lowering the per share price increases their marketability to a wider population of investors without diluting the ownership interests of the existing common shareholders.

In both a stock dividend and a stock split, a reporting entity issues shares to its existing shareholders in proportion to their ownership interest. Generally, a stock dividend is a smaller distribution than a stock split, but whether an issuance of shares is a stock dividend or stock split is not always clear. Both the AICPA and the New York Stock Exchange (NYSE) have indicated that when an issuance of shares is so small in comparison with the shares previously outstanding that it has no apparent effect upon

the share market price, there is a presumption that a stock dividend was declared. Similarly, when the number of additional shares issued is so great that it has, or may reasonably be expected to have, the effect of materially reducing the share price, the transaction should be treated as a stock split.

ASC 505-20-25-3 through ASC 505-20-25-6 and the NYSE have established rules of thumb as to what constitutes a “small” distribution that should be treated as a stock dividend and a “large” distribution that should be treated as a stock split. The SEC’s interpretation in this area is discussed in SEC FRP 214, *Pro Rata Stock Distributions to Shareholders*. Figure FG 4-3 summarizes this guidance.

### Figure FG 4-3

Differentiating between a stock dividend and a stock split

|                               | <b>ASC 505-20-25-3<br/>through<br/>ASC 505-20-25-6</b>  | <b>NYSE manual section<br/>703.02A</b>   | <b>SEC FRP 214</b>   |
|-------------------------------|---|--|--|
| <b>Stock dividend</b>         | Less than 20-25% of the number of shares outstanding prior to the distribution  | Less than 25% of the number of shares outstanding prior to the distribution  | Less than 25% of shares of the same class outstanding  |
| <b>Stock split</b>            | Greater than 20-25% of the number of shares outstanding prior to the distribution   | Equal to or greater than 100% of the number of shares outstanding prior to the distribution  |  |
| <b>Additional information</b> | Distributions of new shares that are less than 20-25% of those previously outstanding or that recur frequently are to be treated as stock dividends even if management representations to shareholders that it is a stock split | Distributions greater than 25% but less than 100% of the number of shares outstanding prior to the distribution are treated as a stock dividend when the distributions assume the character of stock dividends through repetition of issuance under circumstances not consistent with the true intent and purpose of a stock split | Distributions of over 25% may be accounted for as a stock dividend if they are part of a program of recurring distributions and accounting for them as a stock split would be misleading |

Although ASC 505-20-25 uses a different threshold than the NYSE, a reporting entity listed on the NYSE would generally treat a distribution of greater than 25% of the shares outstanding as a stock split.

When a stock dividend in form is determined to be a split in substance, ASC 505-20-50-1 recommends that every effort be made to avoid the use of the word dividend in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannot be done, the transaction be described, for example, as a stock split effected in the form of a dividend.

ASC 260-10-55-12 requires that computations of earnings per share give retroactive recognition to a change in capital structure occurring during the period (or after the close of the period but before the

financial statements are available to be issued) for all periods presented. See FSP 5.12 for balance sheet reporting and FSP 7.6.1 for earnings per share considerations related to stock dividends and stock splits.

#### 4.4.4.1 *Accounting for a stock dividend*

A stock dividend is recorded by transferring the fair value of the shares issued from retained earnings to the related equity accounts as discussed in ASC 505-20-30-3. Retained earnings is charged (debited) for the fair value of the shares, and capital stock (for the par value of the shares) and additional paid-in capital are credited. In those rare instances when the par value of the shares exceeds the fair value of the shares distributed, retained earnings should still be charged for the fair value of the shares, capital stock is credited for the par value of the stock, and additional paid-in capital is charged (debited) for the difference between fair value and par value. If there is no or insufficient paid-in capital, or if the directors vote to charge retained earnings for par value despite the existence of additional paid-in capital, it is acceptable to charge retained earnings.

In the case of stock dividends declared by closely held reporting entities, ASC 505-20-30-5 states that there is no need to capitalize retained earnings other than to meet legal requirements. The reason for this exception to the general rule is that it is presumed that, because of their intimate knowledge of the reporting entity's affairs, shareholders understand the amount of available earnings for dividends. What constitutes a closely held reporting entity for this purpose depends on the circumstances in each case.

Issuance costs incurred in connection with stock dividends should be expensed as incurred. This differs from issuance costs incurred for sales of stock, which are typically recorded as a reduction of the sales proceeds.

Example FG 4-1 illustrates the accounting for a stock dividend.

#### **EXAMPLE FG 4-1**

##### *Accounting for a stock dividend*

FG Corp has 1 million common shares outstanding. The shares have a \$1 par value per share. FG Corp declares a 10% stock dividend and, as a result, issues 100,000 additional shares to current stockholders. FG Corp's common stock price is \$5 per share on the declaration date.

How should FG Corp record the stock dividend?

##### *Analysis*

Upon declaration of the stock dividend, FG Corp should record the following journal entry.

|                                |           |           |
|--------------------------------|-----------|-----------|
| Dr. Retained earnings          | \$500,000 |           |
| Cr. Common stock – par value   |           | \$100,000 |
| Cr. Additional paid-in capital |           | \$400,000 |

### ***Optional dividends***

A reporting entity may issue a dividend to its shareholders and give the shareholders the choice of receiving the dividend in either cash or shares (referred to as an optional dividend). Consistent with the accounting for stock dividends, retained earnings should be charged for an amount equal to the fair value of the shares distributed. When shareholders have the option to elect cash or stock, the number of shares to be issued is a variable number. The amount of retained earnings capitalized for the entire distribution should be equal to the amount of the dividend had it been paid entirely in cash. It is rare that the fair value of the stock dividend would be less than the cash dividend; therefore, the cash dividend should be indicative of the minimum fair value of the shares issued.

### ***Stock dividends when the reporting entity has an accumulated deficit***

There is no specific guidance on the accounting for a stock dividend when a reporting entity has an accumulated deficit rather than retained earnings. The SEC staff has historically taken the view that in this circumstance, the reporting entity should capitalize only the stock's par value from additional paid-in capital.

If a common stock dividend is paid to holders of preferred stock when there is an accumulated deficit, the dividend should be accounted for at fair value with a corresponding increase in loss applicable to common shareholders. Fair value accounting is also appropriate for dividends declared on preferred stock that are payable in the form of additional preferred shares, when payment in additional preferred shares is at the discretion of the issuer. We believe the fair value charge for stock dividends declared on preferred stock should be recorded as a charge to additional paid-in capital when a retained earnings deficit exists by analogy to ASC 480-10-S99-2 (SAB Topic 3.C, *Redeemable Preferred Stock*). That guidance indicates that amortization of a discount to the redemption amount of preferred stock should be charged to additional paid-in capital in the absence of retained earnings.

### ***Fractional shares***

Stock dividends almost always create fractional shares. A reporting entity may address this by selling the fractional shares and distributing cash to shareholders, by issuing special certificates (called a scrip issue) for the fractional shares which are then bought and sold through an agent, by arranging for shareholders to buy or sell fractional shares without a scrip issue, or by issuing fractional share certificates.

Each method of handling fractional shares is accounted for in the same manner as whole shares issued as a stock dividend.

See FSP 5.11.4.2 for information on presentation considerations for fractional shares.

### ***Stock dividends issued to a parent from a subsidiary***

Stock dividends issued from a subsidiary to its parent normally result in a memorandum entry by the parent for the additional shares received. Although the subsidiary may capitalize retained earnings in connection with the stock dividend, ASC 810-10-45-9 states that consolidated retained earnings need not be capitalized.

#### 4.4.4.2 Accounting for a stock split

When a stock split is effected without a change in the par value of the shares, the reporting entity should charge either additional paid-in capital or retained earnings, depending on the directive of the board of directors and legal requirements, and record an offsetting credit to par value for the newly issued shares.

When the par value is changed to reflect the stock split, no entry is required; however, the number of outstanding shares should be increased to reflect the split.

Example FG 4-2 illustrates the effect of a stock split with a change in par value and Example FG 4-3 illustrates the effect of a stock split with no change in par value.

#### EXAMPLE FG 4-2

##### Stock split – change in par value

FG Corp has 1 million common shares outstanding. The shares have a \$1 par value per share. FG Corp effects a 2 for 1 stock split and changes the par value to \$0.50 to reflect the split. FG Corp's shareholders' equity section before the split is shown below.

##### Before the stock split

|  |             |
|--|-------------|
| Common stock ( <i>10 million shares authorized, 1 million shares issued and outstanding, par value \$1</i> ) | \$1,000,000 |
| Additional paid-in capital   | \$4,000,000 |

How should FG Corp account for the stock split?

##### Analysis

FG Corp should not record an entry to record the stock split. However, the details of common stock as presented in its shareholders' equity section should be adjusted as shown below.

##### After the stock split

|   |             |
|---|-------------|
| Common stock ( <i>10 million shares authorized, 2 million shares issued and outstanding, par value \$0.50</i> ) | \$1,000,000 |
| Additional paid-in capital  | \$4,000,000 |

**EXAMPLE FG 4-3****Stock split – no change in par value**

FG Corp has 1 million common shares outstanding. The shares have a \$1 par value per share. FG Corp effects a 2 for 1 stock split and does not change the par value. FG Corp's shareholders' equity section before the split is shown below.

**Before the stock split**

|  |             |
|--|-------------|
| Common stock ( <i>10 million shares authorized, 1 million shares issued and outstanding, par value \$1</i> ) | \$1,000,000 |
| Additional paid-in capital   | \$4,000,000 |

How should FG Corp account for the stock split?

*Analysis*

FG Corp should record the following entry to transfer additional paid-in capital to the par value of common stock.

|                                |             |             |
|--------------------------------|-------------|-------------|
| Dr. Additional paid-in capital | \$1,000,000 |             |
| Cr. Common stock – par value   |             | \$1,000,000 |

**Reverse stock split**

In a reverse stock split the reporting entity merges its outstanding shares to reduce the total number of shares outstanding and increase the per share stock price.

When a reverse stock split is effected without a change in the par value of the shares, the reporting entity should record an entry to reduce the common stock and increase additional paid-in capital. As with ordinary stock splits, no journal entry is required if the par value will change, although the description of common stock in the equity section should be updated.

**4.5 Other transactions with shareholders**

The following sections discuss notes received for common stock, advances to shareholders, and distributions of shares in settlement of litigation. See FG 8.5 for information on shareholder rights plans.

**4.5.1 Notes received for common stock**

When a reporting entity receives a note, rather than cash or other assets, in exchange for common shares or as a contribution to paid-in capital, the note should generally be recognized in equity as an offset to the shares issued. As discussed in ASC 505-10-45-2, recording the note as an asset is generally

not appropriate except in very limited circumstances when there is substantial evidence of an intent and ability to pay the note in a reasonably short period of time.

As discussed in ASC 310-10-S99-2, the SEC staff believes public companies should record notes received in exchange for common stock as contra-equity (rather than an asset) unless the note is paid prior to the issuance of the financial statements. For private companies, in addition to a stated maturity occurring within a short time period, notes secured by irrevocable letters of credit or other liquid collateral can evidence an intent and ability to pay a note in a reasonably short period.

See FSP 5.10.1 for information on the presentation of notes received for common stock.

#### **4.5.2 Advances to, and receivables from, shareholders**

For public companies, ASC 310-10-S99-3 requires that notes or other receivables from a parent or another affiliate be recorded as contra-equity. The SEC staff indicated that the balance sheet display of these or similar items is not determined by the quality or actual value of the receivable or other asset contributed, but by the relationship of the parties and the control inherent in that relationship. Although ASC 310-10-S99-3 discusses this guidance in the context of a partnership, we believe this guidance is applicable to other types of public companies as well.

##### **4.5.2.1 Guidance for private companies**

Other than ASC 505-10-45-2 (discussed in FG 4.5.1), there is no authoritative guidance that deals directly with advances to, and receivables from, shareholders of private companies. With the limited guidance, we believe the decision to reflect an advance to, or receivable from, a shareholder as an asset or, alternatively, as a reduction of shareholders' equity, is dependent upon the specific facts of each situation. Generally, advances to, or receivables from, shareholders should be recognized as a reduction of equity. However, as discussed in ASC 505-10-45-2, there may be some circumstances in which it is acceptable to classify the advance or receivable as an asset. A reporting entity should consider the following factors when determining the appropriate classification.

- The nature of the advance and the circumstances giving rise to the transaction
  - In general, asset classification is only appropriate when an advance to, or receivable from, a shareholder is short-term and results from the normal course of business.
- Whether the receivable has fixed repayment terms and whether it is interest-bearing or collateralized
- The frequency of such advances and prior repayment histories

Question FG 4-1 discusses how a reporting entity should classify equal advances made to shareholders.

#### **Question FG 4-1**

Five shareholders each own 20% of a reporting entity. All five shareholders receive advances in the same amount with no interest or repayment terms. How should the reporting entity account for the advances?



***PwC response***

The reporting entity should account for the advances as a dividend because they are made to all shareholders and do not provide for repayment or the payment of interest.

If, on the other hand, not all of the shareholders received advances, the reporting entity would account for the advances as a reduction of shareholders' equity.

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Question FG 4-2 discusses how a subsidiary should classify periodic advances to its parent when the parent has no means to repay the subsidiary.

**Question FG 4-2**

The parent receives periodic advances from a subsidiary to fund its debt service and has no means to repay the subsidiary. How should the subsidiary classify the advances to its parent in its separate financial statements?

***PwC response***

The subsidiary should classify the advances to its parent as a reduction of shareholder's equity or a dividend, not as an asset, in its separate financial statements.

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Question FG 4-3 discusses how subsidiaries classify advances to their parent when the parent historically repaid the advances.

**Question FG 4-3**

A corporate conglomerate with numerous operating subsidiaries obtains advances from its subsidiaries as an alternative to bank financing. Historically, the parent has repaid the advances. How should the subsidiaries classify the advances to their parent in their separate financial statements?

***PwC response***

If the historical and current operations support the parent's ability and intent to repay the advances, the subsidiaries may classify the advances to their parent as assets in their separate financial statements.

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Question FG 4-4 discusses how a subsidiary should classify receivables from its parent when the subsidiary sells substantially all of its manufactured goods to the parent and recoverability of intercompany receivables has not historically been an issue.

**Question FG 4-4**

A subsidiary sells substantially all of its manufactured goods to its parent. Intercompany receivables are settled periodically and historically, recoverability has not been an issue. How should the subsidiary classify the receivable from its parent in its separate financial statements?

***PwC response***

The subsidiary may classify the receivables from its parent as an asset in its separate financial statements.

Question FG 4-5 discusses how a reporting entity should classify advances made to a shareholder who has failed to repay advances in the past.

**Question FG 4-5**

A reporting entity makes an advance to a shareholder to whom it has a history of making advances. The shareholder has failed to repay advances in the past and the reporting entity has forgiven the indebtedness. How should the reporting entity classify the advance?

***PwC response***

The reporting entity should account for the advance as a reduction of shareholders' equity because the reporting entity's history with the shareholder leaves repayment of the advance in doubt.

Regardless of whether the advance to or receivable from the shareholder is recorded as an asset or in equity, a reporting entity should consider the disclosure requirements of ASC 850, *Related Party Disclosures*. See FSP 26 for information on disclosure of related party transactions.

**4.5.2.2 *Accounting for interest on shareholder loans***

There is no specific guidance on the accounting for interest on shareholder loans. We believe a reporting entity may either recognize the interest as a capital contribution upon receipt, or accrue interest income as earned. We believe recognizing a capital contribution as interest is received is generally the more appropriate treatment unless the note receivable is classified as an asset; in that case, accruing interest income when it is earned would be appropriate.

**4.5.3 *Stock issued to shareholders in settlement of litigation***

A pro rata distribution of common stock to all current shareholders in connection with a litigation settlement can be accounted for as either a stock dividend or stock split rather than as an expense associated with the litigation settlement. If, however, the common stock is distributed only to shareholders of record during the class action period (class action shareholders), the fair value of the shares distributed should be expensed as a litigation settlement. Similarly, if all current shareholders receive a pro rata distribution and the class action shareholders receive an additional distribution, the fair value of the additional shares distributed to class action shareholders should be expensed as a litigation settlement. The shares distributed on a pro rata basis to all current shareholders may be treated as a stock dividend or stock split.

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***Chapter 5:  
Equity-linked instruments  
model—updated December  
2022***

## 5.1 Overview of equity-linked instruments model

A reporting entity may issue an equity-linked instrument to issue shares, repurchase shares or raise financing at a reduced rate. Debt with detachable warrants, convertible debt, and convertible preferred stock are all examples of equity-linked financings. Investors in an equity-linked financing typically receive a lower cash coupon or dividend to compensate the issuer for selling an option on its own equity.

Due to their complexity, understanding equity-linked instruments requires a detailed analysis of the terms, purpose and design of each instrument issued, any related instruments, the underwriting agreement, and other relevant agreements.

The determination of whether an arrangement is in the scope of the equity-linked instruments model could require judgment. In certain situations, arrangements may have different legal forms, but the underlying economics and the substance of the transaction are the same. For example, in a special purpose acquisition company (SPAC) transaction, earnout arrangements may be entered into with the SPAC's sponsors in the form of legally issued and outstanding shares subject to forfeiture if specified performance measures are not met (and thus the share does not vest). At the same time, an earnout arrangement may be entered into with the selling shareholders of the target company as a contract to issue shares, which is conditional upon the performance measures being met. In this instance, for accounting purposes, the earnout arrangement with the SPAC sponsors would be treated as a contract to issue shares (similar to the arrangement entered into with the selling shareholders of the operating company) rather than an outstanding share. In this case, the equity-linked instruments model would be applicable to both arrangements despite the difference in legal form.

This chapter discusses each of the steps and important points to consider when determining whether an equity-linked instrument should be accounted for in its entirety as equity or a liability (or asset), or separated into components.

### ***New guidance***

In August 2020, the FASB issued 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)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the “own stock” scope exception (see FG 5) and certain aspects of the EPS guidance.

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

Guidance in this chapter has been updated to reflect the new ASU and impacted sections are denoted with “after adoption of ASU 2020-06” or “before adoption of ASU 2020-06.”

### ***New guidance***

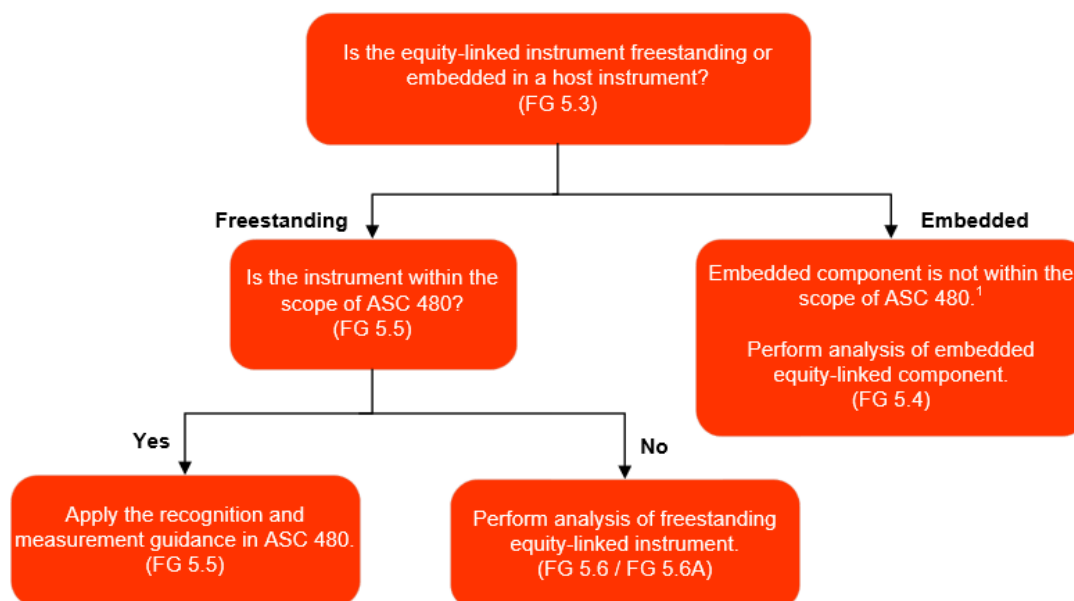
In May 2021, the FASB issued ASU 2021-04, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40)*. The ASU clarifies the guidance related to an issuer’s accounting for modifications or exchanges of freestanding equity-classified written call options (for example, warrants) that remain equity-classified after modification or exchange. The amendments in the ASU are effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. Early adoption is permitted for all entities, including adoption in an interim period. If an entity elects early adoption in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes that interim period. See FG 8.3 for further information related to modifications or exchanges of equity-classified written call options.

## ***5.2 Analysis of an equity-linked instrument***

The analysis to determine the appropriate accounting for an equity-linked instrument is best performed using a multi-step approach. Figure FG 5-1 illustrates the overall model. The analyses described in this chapter are applicable to freestanding instruments and embedded components in host instruments that a reporting entity has not elected (or cannot elect) to carry at fair value.

**Figure FG 5-1**

*Analysis of an equity-linked instrument*



1. Note that hybrid instruments containing embedded equity-linked components should be analyzed to determine whether the entire hybrid instrument is within the scope of ASC 480.

## 5.3 Determine whether an instrument is freestanding or embedded

An equity-linked component can be embedded in a host instrument, such as a debt (e.g., convertible debt) or preferred stock (e.g., convertible preferred stock), that has economic value other than the equity-linked component. Alternatively, an instrument can comprise only the equity-linked component, as is the case with a freestanding warrant. The term “freestanding” also applies to a single financial instrument that comprises more than one option or forward component; for example, a collar, which consists of a written put option and a purchased call option.

ASC 480, *Distinguishing Liabilities from Equity*, applies to an issuer’s classification and measurement of certain freestanding financial instruments. Thus, the first step in determining the accounting for an equity-linked instrument is to determine whether the equity-linked feature is freestanding or embedded in a host instrument. See FG 5.5 for further information on the application of ASC 480.

The ASC Master Glossary provides a definition of a freestanding financial instrument.

### Definition from ASC Master Glossary

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.

In determining whether an equity-linked component is a freestanding financial instrument or embedded in a host instrument, a reporting entity should consider all substantive terms.

A reporting entity should first determine whether the components (1) were issued contemporaneously and in contemplation of each other or (2) were negotiated separately and/or at different points in time.

ASC 815-10-15-6 discusses the accounting for a put or call option added by a third party. While this guidance was written in the context of put or call options attached to debt instruments, the concept of whether a feature is exercisable by a party independent of the issuer or the investor may be helpful in assessing whether a feature is embedded or a freestanding financial instrument.

### ASC 815-10-15-6

A put or call option that is added or attached to a debt instrument by a third party contemporaneously with or after the issuance of a debt instrument shall be separately accounted for as a derivative instrument under this Subtopic by the investor (that is, by the creditor). An option that is added or attached to an existing debt instrument by another party results in the investor having different counterparties for the option and the debt instrument and, thus, the option shall not be considered an embedded derivative. Paragraph 815-15-25-2 states that notion of an embedded derivative in a hybrid instrument refers to provisions incorporated into a single contract, and not to provisions in separate contracts between different counterparties.

A put or call exercisable with an independent third party (whether added contemporaneously with or after issuance) would be accounted for as a freestanding instrument.

Next, a reporting entity should consider whether the components (1) may be legally transferred separately, or (2) must be transferred with the instrument with which they were issued or associated. Components that may be legally transferred separately are generally freestanding. However, a component that must be transferred with the instrument with which it was issued or associated is not necessarily embedded; it may merely be attached.

A reporting entity should also consider whether (1) a right in a component may be exercised separately from other components that remain outstanding or (2) if, once a right in a component is exercised, the other components are no longer outstanding. Since separate exercisability invariably requires the component to first be detached prior to exercise, this is a strong indicator that the components are freestanding.

Example FG 5-1 illustrates an evaluation of whether an equity-linked component is a freestanding financial instrument or embedded in a host contract.

### **EXAMPLE FG 5-1**

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#### **Tranched preferred stock**

FG Corp issues Series A preferred shares to investors. FG Corp grants investors in the Series A preferred shares a warrant to buy Series B preferred shares, if issued, at a fixed price (Series B warrant). The Series B preferred shares will only be issued (and the warrant is only exercisable) upon the receipt of a patent for a specified technology being developed by FG Corp.

The investors can transfer the Series B warrant separate from the Series A shares (i.e., they can sell the Series B warrant and retain the Series A preferred shares).

If the Series B warrant is exercised, the Series A preferred shares are unaffected and remain outstanding.

Is the Series B warrant a freestanding instrument or a component embedded in the Series A preferred shares?

#### *Analysis*

To determine whether the Series B warrant is a freestanding instrument or a component embedded in the Series A preferred shares, FG Corp should consider all of the contractual terms and relevant indicators, including the following points.

- The Series A preferred shares and Series B warrant were issued contemporaneously and in contemplation of each other. This indicates that the Series B warrant may be an embedded component.
- The Series B warrant can be separately transferred; the investor does not have to transfer the Series B warrant with the Series A preferred shares. This indicates that the Series B warrant may be a freestanding financial instrument.

- The Series B warrant can be separately exercised; the Series A preferred shares remain outstanding if the Series B warrant is exercised. This indicates that the Series B warrant may be a freestanding financial instrument.

Based on the above facts, the Series B warrant should be considered a freestanding financial instrument. See FG 7.6 for further information on tranching preferred stock.

Determining whether a component is freestanding or embedded is important because the criteria used to determine the accounting recognition and measurement for freestanding instruments differs from the criteria for embedded components. See FG 8.4 for additional information on allocating proceeds between freestanding financial instruments.

## 5.4 *Analysis of an embedded equity-linked component*

Once a reporting entity determines that an equity-linked component is embedded in a host instrument, it should assess whether the instrument should be (1) accounted for as a single, hybrid instrument, or (2) separated into the host instrument and the equity-linked component.

ASC 815-15-25-1 provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative under the guidance in ASC 815, *Derivatives and Hedging*.

### **ASC 815-15-25-1**

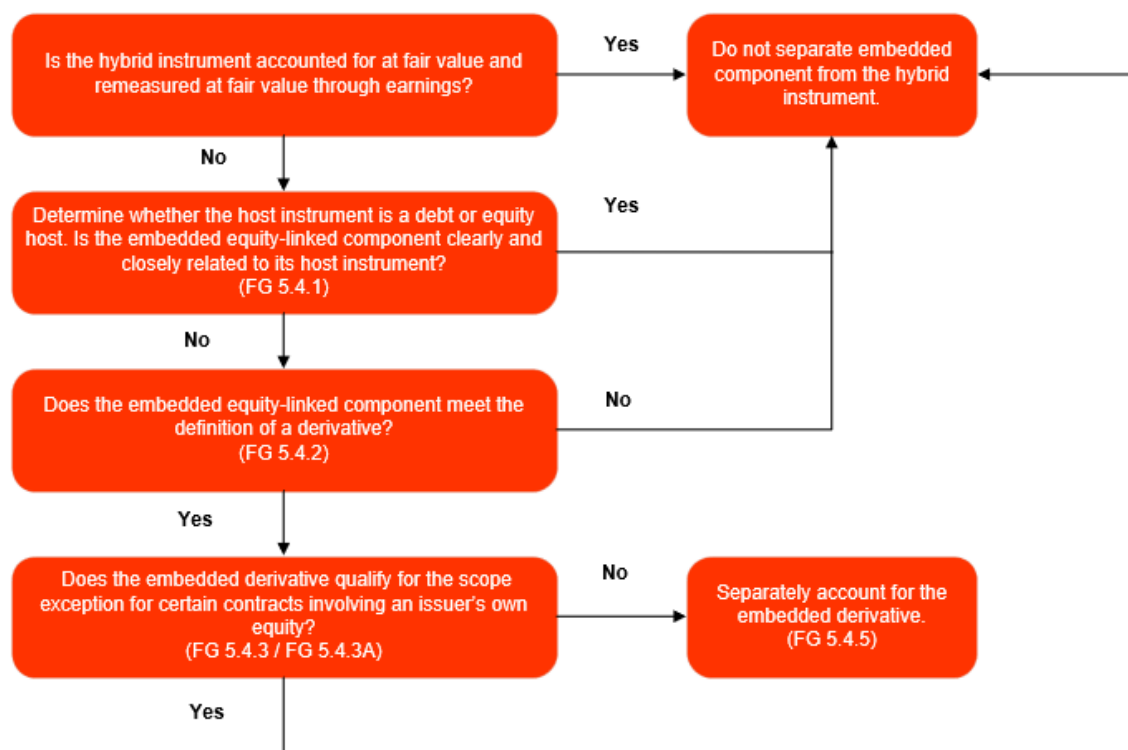
An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

Figure FG 5-2 illustrates the model used to make this assessment.



**Figure FG 5-2**  
Analysis of an embedded equity-linked component



#### 5.4.1 *Whether embedded component is clearly and closely related to host*

A hybrid instrument is a contract that embodies both an embedded derivative and a host contract. A host contract is the instrument or contract that would be issued if a hybrid instrument did not contain an embedded component; it is the hybrid instrument without the embedded component.

When considering whether an embedded equity-linked component is clearly and closely related to its host instrument, a reporting entity should first determine whether the “economic nature” of the host is an equity host or a debt host. An embedded equity-linked component is generally considered clearly and closely related to an equity host; it is not considered clearly and closely related to a debt host. To determine the nature of the host contract, the reporting entity should consider all stated and implied substantive terms and features of the hybrid instrument (inclusive of the embedded component).

Sometimes, the nature of the host contract is straightforward; a hybrid instrument that is legally a debt instrument has a debt host contract. However, determining whether a hybrid instrument that is legally an equity instrument (e.g., a preferred share) is a debt or equity host contract requires judgment. As discussed in ASC 815-15-25-17A, all of the substantive contractual and implied terms of the preferred share, such as the existence of a redemption feature or conversion option, should be considered when determining the nature of the host instrument as debt or equity.

**ASC 815-15-25-17A**

For a hybrid financial instrument issued in the form of a share, an entity shall determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature on the basis of the relevant facts and circumstances. That is, in determining the nature of the host contract, an entity shall consider the economic characteristics and risks of the entire hybrid financial instrument including the embedded derivative feature that is being evaluated for potential bifurcation. In evaluating the stated and implied substantive terms and features, the existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. Although an individual term or feature may weigh more heavily in the evaluation on the basis of the facts and circumstances, an entity should use judgment based on an evaluation of all of the relevant terms and features. For example, an entity shall not presume that the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract, in and of itself, determines whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument. Rather, the nature of the host contract depends on the economic characteristics and risks of the entire hybrid financial instrument.

**ASC 815-15-25-17C**

When applying the guidance in paragraph 815-15-25-17A, an entity shall determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, determining whether those terms and features are debt-like versus equity-like, and weighing those terms and features on the basis of the relevant facts and circumstances. That is, an entity shall consider not only whether the relevant terms and features are debt-like versus equity-like, but also the substance of those terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances). In assessing the substance of the relevant terms and features, each of the following may form part of the overall analysis and may inform an entity's overall consideration of the relative importance (and, therefore, weight) of each term and feature among other terms and features:

- a. The characteristics of the relevant terms and features themselves (for example, contingent versus noncontingent, in-the-money versus out-of-the-money)
- b. The circumstances under which the hybrid financial instrument was issued or acquired (for example, issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized)
- c. The potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes. The assessment of the potential outcomes may be qualitative in nature.

Figure FG 5-3 shows some common attributes (i.e., it is not a comprehensive list) that should be analyzed to determine the nature of the host contract.

**Figure FG 5-3**  
Analyzing the nature of the host contract

| Attribute  | Indicates the instrument is debt-like | Indicates the instrument is equity-like |
|--|---------------------------------------|---|
| Redemption provision                               | ✓                                     |   |
| Conversion option                                  |                                       | ✓                                       |
| Cumulative or mandatory fixed dividends            | ✓                                     |   |
| Discretionary dividends based on earnings          |                                       | ✓                                       |
| Voting rights                                      |                                       | ✓                                       |
| Collateral requirement                             | ✓                                     |   |
| Participation in the residual equity of the issuer |                                       | ✓                                       |
| Preference in liquidation                          | ✓                                     |   |
| Debt-like protective covenants                     | ✓                                     |   |

None of these factors alone is determinative of the nature of a host contract; the terms and conditions as a whole, as well as, potential outcomes should be evaluated and weighted based on the facts and circumstances. For example, a redemption feature that becomes exercisable based on the passage of time would carry more weight than a redemption feature that only becomes exercisable based on an event that is remote of occurring. ASC 815-15-25-17D provides additional guidance on assessing each of these attributes.

Whether the host contract is a debt host or an equity host does not determine the instrument's balance sheet classification. For example, a preferred stock contract that has a debt host for purposes of evaluating embedded components should not necessarily be classified as debt by the issuer.

Example FG 5-2, Example FG 5-3 and Example FG 5-4 illustrate the analysis used to determine whether the nature of a preferred stock host contract is more debt-like or equity-like.

### **EXAMPLE FG 5-2**

#### Convertible, redeemable preferred equity issued by a thinly capitalized entity

FG Corp, an early stage software company, developed a software solution that is licensed to small and medium-sized enterprises. In its most recent fiscal year, FG Corp recorded sales of \$6 million, a 200%

increase over the prior year, and a net loss of \$2 million. Management estimates that existing cash on hand is sufficient to fund FG Corp's operations for an additional 3 months.

To date, FG Corp has raised \$7 million of equity financing (common stock) and \$4 million of debt financing (bank debt). FG Corp has not historically paid dividends and it does not expect to do so in the near to intermediate term.

To raise capital to finance its future operating needs, FG Corp issues Series A preferred stock with a \$2 million stated value (\$2.00 per share) to a single investor, Investor Co. All capital raised by FG Corp will be utilized to increase the size of its sales force and enhance its current software development capabilities.

The key terms of the Series A preferred stock are:

- 8% cumulative, fixed-rate dividends (increases the liquidation preference if not paid in cash)
- Convertible into common stock on a 1:1 basis anytime at the option of the holder
- Automatically converts into common stock upon an initial public offering or sale of the company
- Redeemable at the option of the holder after 5 years for cash equal to the stated value of the Series A preferred stock plus accrued and unpaid dividends
- Voting rights on all significant matters submitted for common stockholder vote on an as-converted basis
- Participates in common stock dividends on an as-converted basis
- No creditor rights
- No collateral requirements

The fair value of FG Corp's common equity was \$1.40 per share on the date the preferred stock was issued. FG Corp's stock price is volatile and could change significantly based on future sales and profitability.

At the time the Series A preferred stock was issued, FG Corp reported an accumulated deficit of \$7 million. Based on its current capitalization and stage of operations, there is significant uncertainty regarding FG Corp's ability to settle the redemption feature in five years, if exercised because the preferred stock is in substance the residual equity in the company. Although FG Corp's current financial position is tenuous, Investor Co expects the business to perform well over time and to exit its investment through conversion into FG Corp's common equity (through a public offering).

Is the nature of the preferred stock host contract more debt-like or equity-like?

### *Analysis*

When considering all relevant terms and features (i.e., the "whole instrument" approach), the host contract should be considered an equity host.

The existence of cumulative, fixed-rate dividends and a non-contingent redemption feature that is exercisable in five years may indicate the existence of a debt host. However, mitigating considerations exist, including the fact that the realization of these dividends may be tied to the redemption of the instrument, which may not occur, and if redemption is required, there is significant uncertainty as to FG Corp's ability to fund those dividends because the preferred stock is effectively the residual equity in the company.

In contrast, the conversion feature would appear to be a strong indicator that the host contract is more akin to an equity host contract. At the time Investor Co acquired the Series A preferred stock, Investor Co understood that FG Corp might encounter going concern issues if an initial public offering or sale of the company did not occur, and that its economic return was therefore tied to a successful initial public offering or sale.

Other equity-like terms and features include the voting rights and common stock dividend participation rights. Because Investor Co has the ability to vote on all significant matters submitted for shareholder vote, the voting feature should be weighed more heavily in the host contract determination than if they were only permitted to vote on protective matters. The ability of Investor Co to participate in common stock dividends on an as-converted basis should not heavily influence the host contract determination, because FG Corp has not paid, and is not expected to pay dividends to common shareholders in the near term. The investor's return of and on its capital is highly dependent upon the business performing successfully and an expected exit through the conversion feature.

Although the Series A preferred stock is redeemable at the option of Investor Co after five years, the instrument's payoff profile is inconsistent with a fixed-income investment with the upside of a residual interest through the conversion feature. If the redemption feature is exercised, FG Corp may lack sufficient assets to redeem the instrument, or may be legally prohibited from doing so if that action would cause FG Corp to become insolvent. Given FG Corp's current financial position and the uncertainty regarding its wherewithal to perform under this potential future obligation, the redemption feature should not be weighed heavily in the host contract determination. This suggests the Series A preferred stock is, in substance, a residual interest in FG Corp.

The host contract contains no creditor rights that would indicate that it is more akin to a debt host contract (e.g., rights to force FG Corp into bankruptcy or participate in a creditor committee to force the company to reorganize or liquidate). The substance of the liquidation preference is questionable and should not heavily influence the host contract determination, because Investor Co is unlikely to receive cash or assets equal to a stated liquidation should the company liquidate because it is effectively the residual equity in the company.

Investor Co appears to be taking residual equity risk, and its ability to achieve a meaningful economic return is dependent upon FG Corp's successful performance and undertaking of an initial public offering or sale to a third party. As a result, the considerations described above indicate that the Series A preferred stock represents an in-substance residual interest in FG Corp and the host contract should be considered to be equity.

### **EXAMPLE FG 5-3**

#### **Convertible, redeemable preferred equity with creditor rights issued by a thinly capitalized entity**

FG Corp, an early stage software company, developed a software solution that is licensed to small and medium-sized enterprises. In its most recent fiscal year, FG Corp recorded sales of \$6 million, a 200%

increase over the prior year, and a net loss of \$2 million. Management estimates that existing cash on hand is sufficient to fund FG Corp's operations for an additional 3 months.

To date, FG Corp has raised \$7 million of equity financing (common stock) and \$4 million of debt financing (bank debt). FG Corp has not historically paid dividends and it does not expect to do so in the near to intermediate term.

To raise capital to finance its future operating needs, FG Corp issued Series A preferred stock with a \$2 million stated value (\$2.00 per share) to a single investor, Investor Co. All capital raised by FG Corp will be utilized to increase the size of its sales force and enhance its current software development capabilities.

The key terms of the Series A preferred stock are:

- 8% cumulative, fixed-rate dividends (increases the liquidation preference if not paid in cash)
- Convertible into common stock on a 1:1 basis anytime at the option of the holder
- Automatically converts into common stock upon an initial public offering or sale of the company
- Redeemable at the option of the holder after 5 years for cash equal to the stated value of the Series A preferred stock plus accrued and unpaid dividends
- Voting rights on all significant matters submitted for common stockholder vote on an as-converted basis
- Participates in common stock dividends on an as-converted basis
- No collateral requirements

The fair value of FG Corp's common equity was \$1.40 per share on the date the preferred stock was issued. FG Corp's stock price is volatile and could change significantly based on future sales and profitability. Public Corp, a well-capitalized public registrant with an investment-grade credit rating, owns a majority of FG Corp's common equity.

At the time Investor Co acquired the Series A preferred stock, significant uncertainty existed regarding the likelihood of an initial public offering. To mitigate this risk, Investor Co requested that Public Corp guarantee FG Corp's obligation to redeem the Series A preferred stock. If FG Corp is unable to perform upon exercise of the redemption feature, Public Corp is obligated to satisfy any part of FG Corp's obligation that remains unfulfilled (i.e., Public Corp has guaranteed FG Corp's written put option on its Series A preferred stock). If Public Corp fails to perform on its guarantee, Investor Co may pursue legal recourse against Public Corp and would have creditor rights against Public Corp if it failed to perform.

Is the nature of the preferred stock host contract more debt-like or equity-like?

### *Analysis*

When considering all relevant substantive terms and features, the host contract should be considered a debt host.

With the exception of the stated dividends, expected outcome and the non-contingent fixed-rate redemption feature, other factors would be evaluated in a manner consistent with Example FG 5-2.

In this fact pattern, the mandatory conversion feature would be weighted less heavily given the uncertainty surrounding the likelihood of an initial public offering. This uncertainty is underscored by Investor Co's request for Public Corp's guarantee of the redemption feature, as it indicates that there is a higher probability that Investor Co will realize its investment through exercise of the redemption feature.

Although Investor Co may not receive the stated dividends on a current basis, it can eventually realize the value of the dividends in cash upon exercise of the redemption feature.

With respect to the redemption feature, although concerns exist regarding FG Corp's obligation to perform if the instrument is redeemed, Public Corp's guarantee of FG Corp's obligation to perform upon redemption influences the substance of the Series A preferred stock's liquidation preference. Furthermore, the presence of creditor rights should FG Corp and Public Corp fail to redeem the preferred shares upon exercise is a strong indicator of the presence of a debt host contract.

Considering the higher probability that Investor Co will exit its investment through exercise of the redemption feature, Public Corp's guarantee of the redemption feature, the substance of the liquidation preference, and the significant risk associated with the conversion feature, the Series A preferred stock represents an in-substance fixed-income investment with residual "upside" and the host contract should be considered a debt host.

#### **EXAMPLE FG 5-4**

##### **Convertible, redeemable preferred equity with a high likelihood of conversion**

In order to satisfy increased demand for its products, Issuer Corp plans to finance the acquisition of new manufacturing equipment through the issuance of convertible preferred stock at a stated value of \$2 per share. The terms of the preferred stock are as follows:

- Redeemable at stated value plus accumulated and unpaid dividends upon a vote of 66% of the holders of preferred stock. The preferred stock is held by a large number of unrelated investors, none of whom individually own more than 5% of the preferred stock issued. The investor group is diverse and includes short-term investors, long-term investors, and strategic investors.
- The purpose of the redemption feature is to provide the investor group with protective rights
- Convertible at the option of the holder after 5 years on a 1:1 basis into Issuer Corp's common shares. Issuer Corp's stock price on the issuance date is \$1.80 per share.
- Voting rights on all significant matters submitted for common stockholder vote on an as-converted basis
- Participation in common stock dividends on an as-converted basis. Issuer Corp has historically paid dividends on its common stock and expects to continue to do so.
- No creditor rights
- No collateral requirements

Investors in Issuer Corp's preferred stock expect to exit their investment through exercise of the embedded conversion option.

Is the nature of the preferred stock host contract more debt-like or equity-like?

### *Analysis*

When considering all substantive relevant terms and features, the host contract should be considered an equity host.

The holder's conversion feature is substantive and therefore should be ascribed weight in the host contract determination. In addition, the preferred stock entitles its holder to vote on all significant matters. As described in ASC 815-15-25-17D(c), voting rights are generally viewed as an equity-like feature, and are given more weight in the host contract determination when the investor has the ability to vote on all significant matters (as opposed to being voting rights that are designed to be protective in nature). Finally, the preferred stock entitles its holder to participate in dividends on the same basis as the common stockholders, another equity-like feature. This feature would be weighted more heavily given that Issuer Corp has historically paid dividends and expects to do so for the foreseeable future.

Although a fixed price redemption feature exists and would be considered a debt-like characteristic, this feature is considered to be more protective in nature and requires 66% of the holders of the preferred stock to vote to exercise it. Given that the preferred stock is widely held by a diverse group of investors with different investment objectives, together with the fact that none of the preferred stockholders are related parties, there are constraints to exercising the redemption feature. As such, the fixed price redemption feature is considered more protective in nature and would be ascribed less weighting in the host contract determination.

Given the additional weight ascribed to the equity-like conversion feature relative to the debt-like redemption option, and the investors' ability to vote on all significant matters and participate in dividends with the common stockholders, the host contract should be considered an equity host.

#### **5.4.2 Whether embedded component meets the definition of a derivative**

ASC 815-10-15-83 provides the definition of a derivative instrument.

#### **ASC 815-10-15-83**

A derivative instrument is a financial instrument or other contract with all of the following characteristics:

- a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
  1. One or more underlyings
  2. One or more notional amounts or payment provisions or both.



- b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Net settlement. The contract can be settled net by any of the following means:
  - 1. Its terms implicitly or explicitly require or permit net settlement.
  - 2. It can readily be settled net by a means outside the contract.
  - 3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

When evaluating whether an equity-linked component meets the definition of a derivative, the net settlement provision in ASC 815-10-15-83(c) often receives the most attention; the provisions in ASC 815-10-15-83(a) and ASC 815-10-15-83(b) are generally met. Many equity-linked contracts (or embedded components) provide for net share settlement (sometimes referred to as cash-less exercise). These contracts would meet the net settlement criteria of ASC 815-10-15-83(c)(1).

To determine whether the net settlement criterion in ASC 815-10-15-83(c) is met, a reporting entity should first determine whether gross physical settlement is required. Gross physical settlement occurs when the asset to be delivered in settlement is both (1) related to the underlying and (2) delivered in quantities equal to the equity component's notional amount. If gross physical settlement is required, a reporting entity should analyze whether the asset (e.g., shares) to be delivered at settlement is readily convertible to cash. The following considerations are typically relevant to that analysis.

- Whether the shares received upon settlement are publicly traded
- Whether the number of shares to be exchanged is large relative to the daily transaction volume
- The effect of any restrictions on the future sale of any shares received

A reporting entity should also consider the appropriate unit of account when determining whether the asset to be delivered at settlement is readily convertible to cash. In assessing whether a contract which can contractually be settled in increments meets the definition of net settlement, a reporting entity must determine whether or not the quantity of the asset to be received from the settlement of one increment is considered readily convertible to cash. If the contract can be settled in increments and those increments are considered readily convertible to cash, the entire contract meets the definition of net settlement. For more information on whether the asset to be delivered is readily convertible to cash, see DH 2.3.5.3.

If gross physical settlement is not required, an equity-linked component may nevertheless meet the net settlement provisions in ASC 815-10-15-83(c)(1) or ASC 815-10-15-83(c)(2). See DH 2 for further information on how to determine whether a contract meets the definition of a derivative.

### 5.4.3 *Whether embedded component meets own equity scope exception—after adoption of ASU 2020-06*

As discussed in FG 5.4, an embedded component that meets the definition of a derivative should be separated from its host instrument and accounted for separately as a derivative when it is not clearly and closely related to its host contract, unless the embedded derivative qualifies for a scope exception.

An embedded equity-linked component that meets the definition of a derivative does not have to be separated from its host instrument if the component qualifies for the scope exception for certain contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

#### **Excerpt from ASC 815-10-15-74**

Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- a. Contracts issued or held by that reporting entity that are both:
  1. Indexed to its own stock (see Section 815-40-15)
  2. Classified in stockholders' equity in its statement of financial position (see Section 815-40-25).

An embedded component is considered indexed to a reporting entity's own stock if it meets the requirements specified in ASC 815-40-15. See FG 5.6.2 for information on these requirements.

An embedded component would be classified in shareholders' equity if it meets the requirements for equity classification in ASC 815-40-25. See FG 5.6.3 for information on these requirements.

### 5.4.3A *Whether embedded component meets own equity scope exception—before adoption of ASU 2020-06*

As discussed in FG 5.4, an embedded component that meets the definition of a derivative should be separated from its host instrument and accounted for separately as a derivative when it is not clearly and closely related to its host, unless the embedded derivative qualifies for a scope exception.

An embedded equity-linked component that meets the definition of a derivative does not have to be separated from its host instrument if the component qualifies for the scope exception for certain contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

#### **Excerpt from ASC 815-10-15-74**

Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- a. Contracts issued or held by that reporting entity that are both:
  1. Indexed to its own stock
  2. Classified in stockholders' equity in its statement of financial position.

An embedded component is considered indexed to a reporting entity's own stock if it meets the requirements specified in ASC 815-40-15. See FG 5.6.2A for information on these requirements.

An embedded component would be classified in shareholders' equity if it meets the requirements for equity classification in ASC 815-40-25. See FG 5.6.3A for information on these requirements.

#### **5.4.4 *Embedded put and call options***

Put features allow an equity holder to require the issuer to reacquire the equity instrument for cash or other assets; call features allow the issuer to reacquire the equity instrument.

As discussed in ASC 815-15-25-20, put and call features are typically not considered clearly and closely related to equity hosts and should be accounted for separately as a derivative provided the other requirements in ASC 815-15-25-1 are met. However, if the issuer concludes that the embedded feature meets the requirements for the scope exception for certain contracts involving an entity's own equity in ASC 815-10-15-74(a) (i.e., the put or call option would be classified in equity), then the put or call option would not have to be separated (because it wouldn't be accounted for as a derivative if it were freestanding). For example, an embedded call option that allows the issuer of an equity instrument (such as common stock) to reacquire that equity instrument may meet this exception; it would not be separated from the host contract by the issuer.

See FG 1.6.1 for additional information on put and call options embedded in debt hosts.

#### **5.4.5 *Accounting for separated instruments***

When a reporting entity separates an embedded derivative from a hybrid instrument, the accounting for the host contract should be based on the accounting guidance applicable to similar host contracts of that type. ASC 815-15-30-2 through ASC 815-15-30-6 provide guidance on allocating the carrying amount of the hybrid instrument between the host contract and the derivative. That guidance requires the derivative to be recorded at fair value and the carrying value assigned to the host contract to represent the difference between the previous carrying amount of the hybrid instrument and the fair value of the derivative; therefore, there is no gain or loss from the initial recognition and measurement of an embedded derivative that is accounted for separately from its host contract.

In rare cases, a reporting entity may issue a hybrid instrument where the fair value of the financial liabilities required to be measured at fair value (e.g., a bifurcated derivatives) exceeds the net proceeds received. In analyzing these fact patterns, we believe (and we understand the SEC staff agrees) a reporting entity should:

- verify that the fair values of the financial liabilities required to be measured at fair value are appropriate under ASC 820,
- evaluate if the transaction was conducted on an arm's length basis (including related party considerations in ASC 850), and
- evaluate all elements of the transaction to determine if there are other rights or privileges that require separate accounting recognition as an asset under other applicable guidance.

In situations where the fair values are appropriate, the transaction was conducted on an arm's length basis, and there are no rights or privileges that require separate accounting recognition as an asset, then the financial liabilities (e.g., the bifurcated derivatives) should be recorded at fair value with the excess of the fair value over the net proceeds received recognized as a loss in earnings.

If the embedded derivative is not an option (e.g., it is a forward component), the terms of the non-option embedded derivative should be determined such that the fair value is zero at inception.

If the embedded derivative is an option, ASC 815-15-30-6 requires the option to be separated and recorded at its fair value based on its stated contract terms. The allocation of proceeds to the separated derivative will typically create a discount or premium in the associated host debt or equity security.

#### **5.4.6 *Reassessment of embedded components—after adoption of ASU 2020-06***

While an analysis of the clearly and closely related criterion in ASC 815-15-25-1(a) is generally a one-time assessment, embedded components should be reassessed at the end of each reporting period to determine whether the embedded component should be separated or, if previously separated, whether it no longer meets the requirements for separation.

ASC 815-40-35-8 provides guidance on the reassessment of instruments within the scope of ASC 815-40.

##### **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.

See FG 5.7 for further information on the accounting for reclassification of instruments.

#### **5.4.6A *Reassessment of embedded components—before adoption of ASU 2020-06***

While an analysis of the clearly and closely related criterion in ASC 815-15-25-1(a) is generally a one-time assessment, embedded components should be reassessed at the end of each reporting period to determine whether the embedded component should be separated or, if previously separated, whether it no longer meets the requirements for separation.

ASC 815-40-35-8 provides guidance on the reassessment of instruments within the scope of ASC 815-40.

##### **ASC 815-40-35-8**

The classification of a contract 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.

See FG 5.7A for further information on the accounting for reclassification of instruments.

## 5.5 *Application of ASC 480*

The guidance in ASC 480 applies to freestanding equity and equity-linked financial instruments and requires a reporting entity to classify certain freestanding financial instruments as liabilities (or in some cases as assets). FG 5.5 discusses the application of ASC 480 relating to when certain instruments are classified as liabilities. This section does not discuss ASC 480-10-S99, which determines whether certain entities should report instruments as mezzanine equity.

### 5.5.1 *Scope of ASC 480*

One of the instruments within the scope of ASC 480 is a mandatorily redeemable financial instrument, which is defined in ASC 480-10-20.

#### **Definition from ASC 480-10-20**

**Mandatorily redeemable financial instrument:** Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

ASC 480-10-25-4, ASC 480-10-25-5, ASC 480-10-25-8 and ASC 480-10-25-14 provide guidance on which instruments are within the scope of ASC 480. Certain mandatorily redeemable financial instruments issued by nonpublic entities are not within the scope of ASC 480, as discussed in FG 5.5.1.4.

#### **ASC 480-10-25-4**

A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

#### **ASC 480-10-25-5**

A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

#### **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.

**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.

The ASC Master Glossary defines monetary value; ASC 480-10-55-2 provides application examples.

**Definition from ASC Master Glossary**

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.

**Question FG 5-1**

Is a purchased option within the scope of ASC 480?

***PwC response***

No. A purchased option, such as a purchased call option, does not create an obligation to repurchase shares; it provides the reporting entity with the right but not the obligation to repurchase shares. Further, ASC 480 does not apply to contracts that will always be in an asset position by the reporting entity as a purchased option would be.

**Question FG 5-2**

Are instruments settled in, or indexed to, the common stock of a consolidated subsidiary within the scope of ASC 480?

***PwC response***

It depends. ASC 480-10-20 defines an issuer's equity shares.

**Definition from ASC 480-10-20**

Issuer's equity shares: The equity shares of any entity whose financial statements are included in the consolidated financial statements.

Therefore, an instrument settled in, or indexed to, a consolidated subsidiary's common stock is within the scope of ASC 480 provided the instrument meets the other criteria in ASC 480. For example, a freestanding written put option on a subsidiary's outstanding shares is within the scope of ASC 480-10-25-8 if cash settled; and within the scope of ASC 480-10-25-14(c) if net share settled. A freestanding purchased call on those same shares is not within the scope of ASC 480 because it does not obligate the reporting entity.

**5.5.1.1 Application of ASC 480—meaning of “predominantly”**

An obligation to issue a variable number of shares is within the scope of ASC 480 if the monetary value is based either solely or *predominantly* on one of the three items listed in ASC 480-10-25-14. The term *predominantly* is included to preclude ASC 480 from being circumvented by embedding a small amount of variability in an instrument based on the reporting entity's equity share price.

ASC 480-10-55-44 provides guidance on performing this analysis. ASC 480-10-55-45 through ASC 480-10-55-52 provides examples of the application of ASC 480-10-25-14. Also, see FG 9.2.4.1 for an example of the evaluation of predominance for an accelerated share repurchase transaction.

**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.

ASC 480 does not provide explicit guidance on the meaning of “predominantly”; it could mean “more-likely-than-not” (i.e., 50.1%, consistent with predominance, defined as the “greater amount”) or some higher threshold (e.g., probable, consistent with the objective of not allowing the standard to be circumvented by embedding a “small” amount of variability). We believe that “predominantly,” as used in ASC 480-10-25-14, can be interpreted as either a “more-likely-than-not” or a higher threshold; a reporting entity should elect an accounting policy and apply it consistently.

**5.5.1.2 Financial instrument with multiple components**

ASC 480-10-55 provides several examples of the application of the scope provisions to certain freestanding instruments comprised of more than one option or forward contract.

As discussed in ASC 480-10-25-15, two or more freestanding financial instruments should generally not be combined to determine whether the instruments are within the scope of ASC 480; however, if the instruments should be combined under the provisions of ASC 815, they should also be combined for purposes of applying ASC 480. Since ASC 480 requires a separate contract-by-contract evaluation, oftentimes the accounting treatment will be dictated by whether different instruments are structured in a single contract or entered into as separate contracts. Figure FG 5-4 provides examples of instruments that may have different accounting based on whether they are executed as a single instrument or multiple instruments.

### Figure FG 5-4

#### Accounting for instruments with multiple components

|   | <b>Within scope of<br/>ASC 480</b> | <b>Outside scope of<br/>ASC 480</b> |
|---|------------------------------------|-------------------------------------|
| <b>Separate freestanding contracts</b>  |                                    |                                     |
| a. Written put option   | ✓                                  |                                     |
| b. Purchased call option  |                                    | ✓                                   |
| c. Outstanding share of common stock (with no redemption features)                              |                                    | ✓                                   |
| d. Purchased put option   |                                    | ✓                                   |
| e. Written call option on non-redeemable stock  |                                    | ✓                                   |
| f. Written call option on redeemable stock  | ✓                                  |                                     |
| <b>Combined (single) contract</b>   |                                    |                                     |
| g. Collar (e.g., a written put @ \$10/share and a purchased call @ \$18/share)                  | ✓                                  |                                     |
| h. Net purchased put option (e.g., a purchased put @ \$12/share and a written put @ \$10/share) |                                    | ✓                                   |
| i. Net written put option (e.g., a written put @ \$12/share and a purchased put @ \$10/share)   | ✓                                  |                                     |
| j. Collar embedded in an outstanding share of common stock                                      |                                    | ✓                                   |
| k. Puttable stock (i.e., outstanding share of common stock and written put option)              |                                    | ✓                                   |



As Figure FG 5-4 illustrates:

- A freestanding written put option (a) falls within the scope of ASC 480, but a purchased call option (b) is outside the scope of ASC 480; however, if the written put option and purchased call option are combined into a single contract, that collar contract, as in (g), is within the scope of ASC 480.
- A written put option may be outside the scope of ASC 480 if it only serves to reduce the potential gains of a purchased put option in a combined contract, as is the case in (h); however, if the written put option is only partially offset by the purchased put option and thus creates a net written put option, the entire contract is within the scope of ASC 480, as is the case in (i).
- A separate written put option (a) and an outstanding share of common stock (c) are accounted for different than puttable stock, as in (k), which is a combination of an outstanding share of stock and a written put option.

While a written put embedded in a share of stock generally does not require the share to be classified as a liability, reporting entities should consider other applicable reporting requirements. For reporting entities subject to SEC rules, these instruments should be presented in the mezzanine (or temporary) equity section. See FG 7.3.4 for further information on mezzanine equity classification.

### 5.5.1.3 *Nonsubstantive or minimal features*

As noted in FG 5.5, ASC 480 applies only to certain freestanding financial instruments. To avoid attempts to circumvent the application of ASC 480 by embedding a minimal or nonsubstantive feature in a freestanding financial instrument, the guidance specifies that nonsubstantive features should be disregarded when determining whether ASC 480 applies. ASC 480 provides examples of features that may be considered nonsubstantive.

The assessment of whether a feature is minimal or nonsubstantive is performed only at inception of a financial instrument; no further assessment is required. This assessment requires judgment and must consider not only the legal terms of an instrument, but also other relevant facts and circumstances.

As discussed in FG 5.5.1.2, a written put option is classified as a liability under ASC 480 because it obligates the reporting entity to deliver cash to repurchase shares. On the other hand, a written put embedded in a share of stock is not classified as a liability. However, as illustrated in ASC 480-10-55-41, a reporting entity that embeds a written put option into a nonsubstantive host instrument should disregard that host instrument and account for the written put option as a liability.

#### **ASC 480-10-55-41**

An entity issues one share of preferred stock (with a par amount of \$100), paying a small dividend, and embeds in it an option allowing the holder to put the preferred share along with 100,000 shares of the issuer's common stock (currently trading at \$50) for a fixed price of \$45 per share in cash. The preferred stock host is judged at inception to be minimal and would be disregarded under paragraph 480-10-25-1 in applying the classification provisions of this Subtopic. Therefore, under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement), that instrument would be analyzed as a written put option in its entirety, classified as a liability, and measured at fair value.

If a share of mandatorily redeemable preferred stock contains a conversion feature, it would not be classified as a liability due to the inclusion of the conversion feature. However, as illustrated in ASC 480-10-55-12, if the conversion price at inception is extremely high relative to the current share price (so that the likelihood of the stock price ever reaching the conversion price is remote), it would be considered nonsubstantive and therefore, disregarded.

#### **ASC 480-10-55-12**

If the conversion option were nonsubstantive, for example, because the conversion price is extremely high in relation to the current share price, it would be disregarded as provided in paragraph 480-10-25-1. If that were the case at inception, those preferred shares would be considered mandatorily redeemable and classified as liabilities with no subsequent reassessment of the nonsubstantive feature.

A conversion option that is nonsubstantive at inception is always considered nonsubstantive in subsequent periods. Similarly, a conversion option that is substantive at inception is always considered substantive and does not subsequently become nonsubstantive as a result of a substantial decline in the issuer's stock price.

Although a feature may be nonsubstantive for purposes of applying ASC 480, that feature should not necessarily be ignored for other accounting purposes.

#### **5.5.1.4 Mandatorily redeemable instruments—nonpublic reporting entities**

ASC 480-10-15-7A through ASC 480-10-15-7D provide a scope exception for certain mandatorily redeemable financial instruments of nonpublic reporting entities.

#### **ASC 480-10-15-7A**

The classification, measurement, and disclosure guidance in this Subtopic does not apply to mandatorily redeemable financial instruments that meet both of the following:

- a. They are issued by nonpublic entities that are not Securities and Exchange Commission (SEC) registrants.
- b. They are mandatorily redeemable, but not on fixed dates or not for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index.

#### **ASC 480-10-15-7B**

Mandatorily redeemable financial instruments issued by an SEC registrant are not eligible for the scope exception in paragraph 480-10-15-7A, even if the entity meets the definition of a nonpublic entity.

#### **ASC 480-10-15-7C**

Some entities have issued shares that are required to be redeemed under related agreements. If the shares are issued with a redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable. If an entity with such shares and redemption agreement is a nonpublic entity that is not an SEC registrant, those mandatorily redeemable shares meet the scope exception in paragraph 480-10-15-7A if they meet the conditions specified in that paragraph.

**ASC 480-10-15-7D**

Although the disclosure requirements of this Subtopic do not apply for those mandatorily redeemable instruments of certain nonpublic companies that meet the scope exception in paragraph 480-10-15-7A, the requirements of Subtopic 505-10 still apply. In particular, paragraph 505-10-50-3 requires information about the pertinent rights and privileges of the various securities outstanding, which includes mandatory redemption requirements. Paragraph 505-10-50-11 also requires disclosure of the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.

A reporting entity is considered nonpublic for purposes of this scope exception provided it meets the definition in ASC 480-10-20.

**Definition from ASC 480-10-20**

Nonpublic entity: Any entity other than one that meets any of the following criteria:

- a. Has equity securities that trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally
- b. Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market
- c. Is controlled by an entity covered by the preceding criteria.

An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity.

Even if a mandatorily redeemable financial instrument is not within the scope of ASC 480, the disclosure requirements for mandatorily redeemable instruments in ASC 505 are still required. See FSP 5 for further information on the disclosure requirements of mandatorily redeemable instruments.

**5.5.1.5 Mandatorily redeemable noncontrolling interests**

Under ASC 480-10-15-7E, certain mandatorily redeemable noncontrolling interests are exempt from certain provisions of ASC 480.

**ASC 480-10-15-7E**

The guidance in this Subtopic does not apply to mandatorily redeemable noncontrolling interests (of all entities, public and nonpublic) as follows:

- a. The classification and measurement provisions of this Subtopic do not apply to mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by the subsidiary, under the only upon liquidation exception in paragraphs 480-10-25-4 and 480-10-25-6, but would be classified as liabilities by the parent in consolidated financial statements.
- b. The measurement provisions of this Subtopic do not apply to other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in

the mandatorily redeemable noncontrolling interest. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other predecessor literature (for example, in paragraph 480-10-S99-3A) continues to apply.

See BCG 6.2 for additional information on the classification of noncontrolling interests.

### **5.5.2 ASC 480—Initial measurement and recognition**

Financial instruments within the scope of ASC 480, other than physically settled forward repurchase contracts, should be initially measured at fair value. See FG 9.2.2.1 for information on physically settled forward repurchase contracts.

### **5.5.3 ASC 480—Subsequent measurement**

Most financial instruments within the scope of ASC 480 should be subsequently measured at fair value, with changes in fair value recorded in earnings, typically as other income or expense unless other GAAP specifies another measurement attribute as stated in ASC 480-10-35-5. The two instruments whose subsequent measurement is addressed by ASC 480 that are not measured at fair value are (1) mandatorily redeemable financial instruments and (2) physically settled forward repurchase contracts for a fixed number of shares.

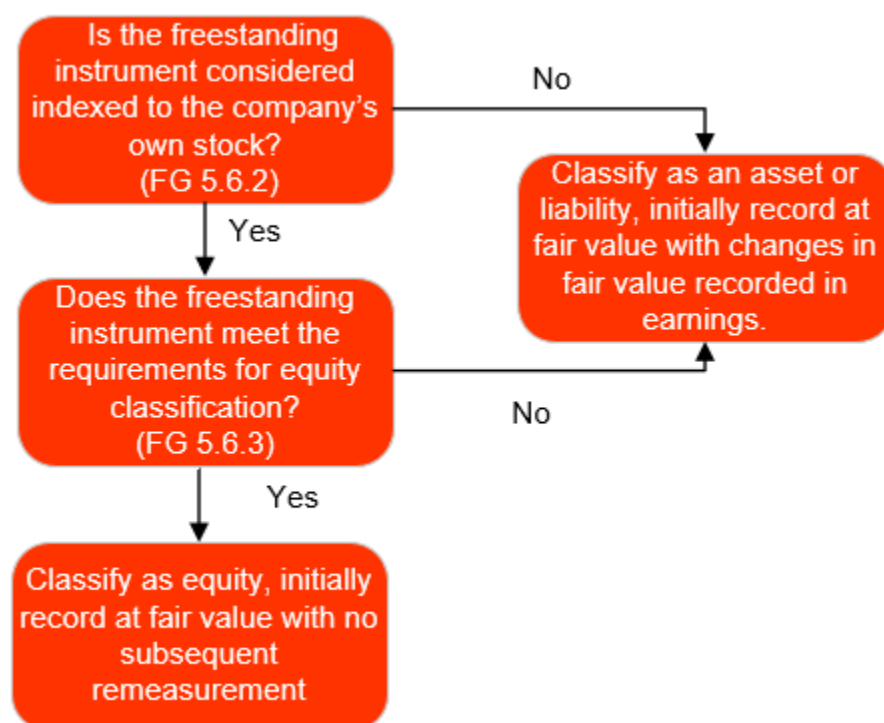
Financial instruments that fall into the scope of ASC 480 subsequent to issuance (e.g., conditionally redeemable preferred stock that becomes mandatorily redeemable) should be reclassified as a liability and initially measured at fair value. No gain or loss should be recorded as a result of the reclassification.

See FG 7.3.1.1 for information on mandatorily redeemable instruments. See FG 9.2.2.1 for information on physically settled forward repurchase contracts.

## **5.6 Analysis of a freestanding equity-linked instrument—after adoption of ASU 2020-06**

Once a reporting entity has determined that a freestanding financial instrument should not be accounted for using the guidance in ASC 480, the next step is to determine whether the instrument should be accounted for as (1) an equity instrument or (2) a liability (or in some cases an asset) under the guidance in ASC 815-40, *Derivatives and Hedging—Contracts in Entity’s Own Equity*. Figure FG 5-5 summarizes the steps in the analysis of a freestanding equity-linked instrument.

**Figure FG 5-5**  
Analysis of a freestanding equity-linked instrument



As illustrated in Figure FG 5-5, the steps used to analyze a freestanding equity-linked instrument differ from the analysis of an embedded equity-linked component in that an embedded equity-linked component need not be evaluated under ASC 815-40 if it does not meet the definition of a derivative. Consequently, an embedded non-derivative equity-linked component should not be accounted for separately.

The guidance in ASC 815-40 must be applied to freestanding instruments, regardless of whether the instrument meets the definition of a derivative. For example, a freestanding warrant on the shares of a private reporting entity may not meet the definition of a derivative because it cannot be net settled and the underlying equity is not readily convertible to cash. However, the instrument should be analyzed to determine whether it would be considered indexed to the reporting entity's own stock and, if so, to determine whether the instrument meets the additional requirements for equity classification.

If an instrument is not considered indexed to the reporting entity's own stock, it should be classified as an asset or a liability and recorded at fair value with changes in fair value recorded in the income statement. This applies to freestanding instruments that meet the definition of a derivative, and those that do not.

An instrument that is considered indexed to a reporting entity's own stock based on the guidance in ASC 815-40-15 should be evaluated to determine if it meets the requirements for equity classification in ASC 815-40-25; see FG 5.6.3. If these requirements are also met, equity classification is appropriate and there is no subsequent remeasurement. If the requirements for equity classification are not met, the instrument should be classified as an asset or liability and recorded at fair value with changes in

fair value recorded in the income statement. This applies to freestanding instruments that meet the definition of a derivative, and those that do not.

See FG 8 for discussion of the model for allocating proceeds and issuance costs to freestanding instruments issued together, such as debt with detachable warrants.

### **5.6.1 Whether the instrument meets the definition of a derivative—after adoption of ASU 2020-06**

ASC 815-10-15-83 provides the definition of a derivative instrument. Many equity derivatives meet two of the three criteria necessary to meet the definition of a derivative: (1) there is an underlying and a notional amount or payment provision, and (2) there is little or no initial net investment. The third criterion, “net settlement,” is often the determining criterion.

A freestanding equity-linked instrument meets the net settlement criterion in ASC 815-10-15-83(c)(1) if it can be net share settled, even if the underlying shares are not readily convertible to cash, as illustrated in ASC 815-10-55-90.

#### **ASC 815-10-55-90**

This Example illustrates the concept of net share settlement. Entity A has a warrant to buy 100 shares of the common stock of Entity X at \$10 a share. Entity X is a privately held entity. The warrant provides Entity X with the choice of settling the contract physically (gross 100 shares) or on a net share basis. The stock price increases to \$20 a share. Instead of Entity A paying \$1,000 cash and taking full physical delivery of the 100 shares, the contract is net share settled and Entity A receives 50 shares of stock without having to pay any cash for them. (Net share settlement is sometimes described as a cashless exercise.) The 50 shares are computed as the warrant’s \$1,000 fair value upon exercise divided by the \$20 stock price per share at that date.

A freestanding instrument may also meet the net settlement criterion if there is a market that offers a ready opportunity to sell the contract, or if the shares underlying the instrument are readily convertible to cash. See FG 5.4.2 and DH 2.3.5 for further information on the definition of a derivative.

### **5.6.2 Whether the instrument is indexed to entity’s own stock—after adoption of ASU 2020-06**

The guidance in ASC 815-40-15 requires a reporting entity to apply a two-step approach—it requires the evaluation of an instrument’s or embedded component’s contingent exercise provisions and then the instrument’s or embedded component’s settlement provisions. The determination of which step a feature should be analyzed under is critical to the analysis as the evaluation under each step is significantly different.

Before application of the two-step approach to determine whether the instrument is indexed to the entity’s own stock, it is important for a reporting entity to understand the unit of account for freestanding contracts or the terms of the embedded derivative being analyzed. For freestanding contracts (that are not embedded in host instruments) judgment is required to determine whether the unit of account should be the overall contract or separate contracts within the overall arrangement. Specifically, a reporting entity must evaluate whether the overall contract represents a single freestanding financial contract or if the overall contract is comprised of a number of separate freestanding financial contracts. See FG 5.3 for further information, including the definition of a

freestanding financial instrument. Similarly, judgment is required in determining the terms of the feature being evaluated and whether it consists of a single embedded derivative or multiple embedded derivatives.

ASC 815-40-55-26 through ASC 815-40-55-48 contain a number of examples illustrating the application of the two-step approach to determining whether an instrument is indexed to a reporting entity's own stock.

#### **5.6.2.1 Step one—exercise contingencies—after adoption of ASU 2020-06**

Any contingent provision that affects the holder's ability to exercise the instrument or embedded component must be evaluated. For example, holders may have a contingent exercise right or may have their right to exercise accelerated, extended, or eliminated upon satisfaction of a contingency.

ASC 815-40-15-7A and ASC 815-40-15-7B provide guidance on the evaluation of contingent exercise provisions (step 1).

##### **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).

##### **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).

For example, if a warrant becomes exercisable only if the S&P 500 increases by 10% or the price of oil decreases by 10%, the contingency would fail this step and the warrant would not be considered indexed to the reporting entity's own stock. In contrast, if the warrant became exercisable only if the reporting entity's stock price increased 10%, this step of the guidance would be met, and the analysis would proceed to step two.

Example FG 5-5 and Example FG 5-6 illustrate the application of step one of the indexation guidance.

### **EXAMPLE FG 5-5**

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#### **Evaluation of exercise contingencies – two potential settlement alternatives**

A company enters into an arrangement to issue shares with the following provisions:

- Three-year maturity
- 1,000 shares will be issued if the volume weighted average price (VWAP) of the company's stock is greater than \$15 for any 20 days within a 30-day trading period

#### *Analysis*

Since this arrangement provides for only two potential settlement alternatives (either no shares are issued or 1,000 shares are issued), it would be analyzed under step one of the indexation guidance (i.e., it is an exercise contingency). The event that triggers the issuance of a fixed number of shares is based on an observable market price, but it is the price of the company's shares. If the other requirements in ASC 815-40 are met (see FG 5.6.3), this arrangement may be considered an equity instrument.

### **EXAMPLE FG 5-6**

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#### **Evaluation of multiple exercise contingencies**

A company enters into an arrangement under which a fixed number of shares will be issued if, during the subsequent three-year period:

- the VWAP of the company's stock is greater than \$15 for any 20 days within a 30-day trading period or
- there is a change in control of the company.

#### *Analysis*

Since this arrangement only provides for two potential settlement alternatives (either no shares are issued or a fixed number of shares are issued) it would be analyzed under step one of the indexation guidance (i.e., each alternative is an exercise contingency). In instances when there are multiple contingencies that could cause the issuance of shares, each contingency and the interaction of the contingencies needs to be analyzed. One of the events that triggers the issuance of a fixed number of shares is based on an observable market price, but it is the price of the company's shares. The other event that could trigger the issuance of a fixed number of shares is if there is a change in control, which is not an observable price or an observable index. If the other requirements in ASC 815-40 are met (see FG 5.6.3), this arrangement may be considered an equity instrument.

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### 5.6.2.2 *Step two—settlement provisions—after adoption of ASU 2020-06*

ASC 815-40-15-7C provides guidance on how to evaluate an instrument's settlement provisions to determine whether the instrument is indexed to the reporting entity's own stock. This guidance is often referred to as the "fixed for fixed" rule.

#### **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.

The strike price or the number of shares used to calculate the settlement amount is not considered fixed if the terms of the instrument or embedded component allow for any potential adjustment (except as discussed below), regardless of the probability of the adjustment being made or whether the reporting entity can control the adjustment.

ASC 815-40-15-7E discusses the exception to the "fixed for fixed" rule. This exception allows an instrument to be considered indexed to the reporting entity's own stock even if adjustments to the settlement amount can be made, provided those adjustments are based on standard inputs used to determine the value of a "fixed for fixed" forward or option on equity shares (and the step one analysis 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.

Including other variables, or incorporating a leverage factor that increases the instrument's exposure to the variables in ASC 815-40-15-7E, would preclude the instrument from being considered indexed to the reporting entity's own stock.

Example FG 5-7 through Example FG 5-11 illustrate the application of step two of the indexation guidance.

### **EXAMPLE FG 5-7**

#### **Evaluation of an arrangement with multiple potential settlement alternatives**

A company enters into an arrangement to issue shares with the following provisions:

- Three-year maturity
- 100,000 shares will be issued if the VWAP of the company's stock is greater than \$15 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$20 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$25 for any 20 days within a 30-day trading period

#### *Analysis*

This arrangement provides for multiple settlement alternatives. The contract could result in the issuance of 0, 100,000, 200,000, or 300,000 shares based on whether VWAP exceeds targeted prices. When evaluated under step one of the indexation guidance, in all scenarios, the event that triggers the issuance of shares is based on an observable market price, but it is the price of the company's shares. However, unlike Example FG 5-5, since there could be a different number of shares issued as a result of the multiple settlement alternatives (i.e. 0, 100,000, 200,000, or 300,000 shares), the arrangement would need to be analyzed under step two of the indexation guidance.

Under step two of the indexation guidance, stock price determines the number of shares to be issued, which is an input into a "fixed-for-fixed" valuation model. If the other requirements in ASC 815-40 are met (see FG 5.6.3), this arrangement may be considered an equity instrument.

## EXAMPLE FG 5-8

### Evaluation of an arrangement with multiple potential settlement alternatives, including a change in control event

A company enters into an arrangement under which additional shares will be issued if during the subsequent three-year period, certain thresholds are met, as follows:

- 100,000 shares will be issued if the VWAP of the company's stock is greater than \$15 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$20 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$25 for any 20 days within a 30-day trading period
- 300,000 shares will be issued if there is a change in control of the company

#### *Analysis*

This arrangement provides for multiple settlement alternatives. The contract could result in the issuance of 0, 100,000, 200,000, or 300,000 shares based on whether the VWAP exceeds targeted prices. In addition, if there is a change in control, 300,000 shares are issued. Since there could be a different number of shares issued, it would be analyzed under step two of the indexation guidance.

Stock price impacts the number of shares to be issued, which is an input into a "fixed-for-fixed" valuation model. However, in the event of a change in control, 300,000 shares are issued, which is not an input into a "fixed-for-fixed" valuation model. As a result, this arrangement would be required to be classified as a liability and measured at fair value with changes in fair value recorded in current earnings.

There may be other arrangements similar to Example FG 5-8 with multiple stock price triggers and other triggers that should be analyzed. For example, an instrument with multiple stock price triggers might also include the following provisions:

- If there is a change in control of the company, and stock price is greater than \$20, then 300,000 shares are issued
- If there is a liquidation of the company, then 300,000 shares are issued
- If there is a change in control of the company, and stock price is greater than \$10, then a pro-rata number of shares between 0 and 100,000 will be issued

Similar to Example FG 5-8, when analyzed under step two, these fact patterns (when coupled with multiple stock price triggers) will result in the instrument being liability classified and measured at fair value with changes in fair value reported in current earnings because change in control or a liquidation of the company are not inputs into a "fixed-for-fixed" pricing model.

## EXAMPLE FG 5-9

### Evaluation of an arrangement to issue shares with multiple settlement alternatives and measures

A company enters into an arrangement under which additional shares will be issued if during the subsequent three-year period, certain thresholds are met, as follows:

- 100,000 shares will be issued if the VWAP of the company's stock is greater than \$15 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$20 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$25 for any 20 days within a 30-day trading period
- If there is a change in control of the company, the price at which the change in control occurred will be used to determine the number of shares to be issued (based upon the same stock price triggers above) as opposed to the VWAP

#### *Analysis*

This arrangement provides for multiple settlement alternatives. The contract could result in the issuance of 0, 100,000, 200,000, or 300,000 shares based on whether the VWAP or the change in control price exceeds targeted prices. For the purposes of this example, the application of step 1 of the indexation guidance is not illustrated. Since there could be a different number of shares issued (0, 100,000, 200,000, or 300,000), it would be analyzed under step two of the indexation guidance.

In evaluating the arrangement under step two, it is important to determine if stock price is the only measure that can determine the number of shares to be issued because stock price is an input into a "fixed-for-fixed" valuation model. If the manner in which the change in control price is determined and VWAP over a short time period are both reasonable means in which to measure the fair value of the company's stock, the arrangement may be considered indexed to the entity's own stock.

Assessing whether the change in control price is a reasonable measure of the fair value of the company's stock requires careful consideration of (1) the events considered to be a change in control under the arrangement and (2) the manner in which the change in control price is calculated. For example, many change in control provisions include a company selling substantially all of its assets. If the change in control price calculation does not consider the potential dilutive impact of this arrangement (and potentially other arrangements), it would not be deemed to be a reasonable manner in which to calculate the fair value of the company's stock. If, however, the change in control price calculation considers the potential dilutive impact of this arrangement (and potentially other arrangements), it may be deemed to be a reasonable manner in which to calculate the fair value of the company's stock. Calculations that consider the dilutive impact of the arrangement itself are complex and likely require iterative or simultaneous equation calculations.

If the change in control price calculation is not a reasonable manner in which to calculate the fair value of the company's stock, the arrangement would be required to be classified as a liability and measured at fair value with changes in fair value recorded in current earnings.

If the change in control price calculation is a reasonable manner in which to calculate the fair value of the company's stock and the other requirements in ASC 815-40 are met (see FG 5.6.3), this arrangement may be considered an equity instrument.

### EXAMPLE FG 5-10

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#### Evaluation of a warrant issued in a SPAC transaction

A warrant issued in a SPAC transaction exercisable for 1 share of common stock over a five-year term has a strike price of \$11.50 and includes the following provisions:

- In the event that the stock price of the company exceeds \$18, the company can redeem the warrant for \$0.01.
- If the company elects to redeem the warrant, the warrant holder can exercise the warrant.
- The company cannot redeem the warrant while it is held by the sponsor/founder of the SPAC; the company is only able to redeem the warrant if the sponsor/founder transfers the warrant.
- In the event that there is a change in control in which shareholders receive a specified form of consideration:
  - the warrant holders will have the ability to exercise their warrants,
  - the exercise price is reduced in an effort to compensate the holders for lost time value of the option (because they would be exercising before the warrant's maturity date - a make-whole provision) based on an option valuation model, and
  - the option valuation model works differently if the warrant is held by the founder/sponsor (not reflecting any ability of the company to redeem the warrants if transferred to a third party) or a third party (reflecting the company's ability to redeem the warrants).

#### *Analysis*

In this example, the make-whole provision (exercise price reduction) is calculated differently depending on who holds the warrant (the founder/sponsor or a third party). The identity of the holder of the warrant is not an input to a "fixed-for-fixed" valuation model. This warrant would not be considered indexed to a company's own stock. As a result, this warrant would be required to be classified as a liability and measured at fair value with changes in fair value recorded in current earnings.

In analyzing these features, it is important to understand if the warrant's settlement amount can be impacted by who holds the warrant. In this example, the warrants issued to sponsors/founders contain provisions that change potential settlement amounts if the warrants are transferred to a third party. However, the SPAC warrants that are held by the public may not contain such features. If the warrants do not have any features that could change the settlement amount or how settlement is calculated, the warrants may be considered indexed to an entity's own stock.

We understand that this is an example of a provision addressed in the SEC's public statement (see FG 5.6.4 for additional information).

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There may be other features in a warrant agreement that result in changes to settlement amounts or how settlement amounts are calculated depending on who holds the warrant. For example:

- In the event the company elects to redeem certain warrants and the holders exercise their warrants, the settlement amount may be different if the holder is a director or officer of the company.
- Some warrants permit net share settlement upon exercise (frequently referred to as a cashless exercise). In some warrant agreements, the inputs used to calculate the net settlement amount (i.e., shares to be delivered) may be different depending on if the warrant is held by the founder/sponsor or if it is held by a third party. For example, settlement could be based on:
  - the ten day VWAP when held by a sponsor/founder and the average closing price of the stock over a ten-day period when held by another party, or
  - the trailing average of stock price based on the date a warrant is exercised when held by the sponsor/founder and based on the date the warrant is redeemed by the company if held by others.

Based on the guidance in the SEC’s public statement (see FG 5.6.4), these warrants would not be considered indexed to a company’s own stock because the holder of the warrant can impact the settlement amount and the identity of a holder is not an input into a “fixed for fixed” valuation model. As a result, these warrants would be classified as liabilities and reported at fair value with changes in fair value reported in current earnings.

### **EXAMPLE FG 5-11**

**Evaluation of arrangements when the number of shares issuable may increase based on employee behavior (sometimes referred to as a “last person standing provision”)**

Arrangements in the company’s stock are issued to investors and employees with vested and unvested stock compensation awards. Assume that additional shares will be issued if during a three-year period, certain thresholds are met, as follows:

- 100,000 shares will be issued if the VWAP of the company’s stock is greater than \$15 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company’s stock is greater than \$20 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company’s stock is greater than \$25 for any 20 days within a 30-day trading period

The arrangements issued to employees with unvested options are subject to continued employment vesting requirements (which may be based on the employment vesting requirements in their unvested stock compensation awards). In the event that these arrangements are forfeited by employees, the number of shares that could be issued under these arrangements are “re-allocated” on a pro-rata basis to the other holders. This is sometimes referred to as a “last person standing provision”.

## *Analysis*

The arrangements issued to unvested option holders in this case would be considered compensation and subject to the guidance in ASC 718. See SC 1.3 for further discussion on awards in the scope of ASC 718 as well as SC 2 and SC 3 for measurement and classification considerations. For the arrangements not subject to ASC 718, analysis under ASC 815-40 is required.

These arrangements provide for multiple settlement alternatives. In total the arrangement could result in the issuance of 0, 100,000, 200,000, or 300,000 shares based on whether the VWAP exceeds targeted prices. In addition, the number of shares an individual holder may receive is also based on the continued employment of certain employees that were granted these arrangements. The number of shares an individual holder receives may increase based on the forfeiture of the arrangements granted to employees with unvested options. Since there could be a different number of shares issued depending on certain events, the arrangements would be analyzed under step two of the indexation guidance. For the purposes of this example, the application of step 1 of the indexation guidance is not illustrated.

In evaluating the arrangements under step two, the vesting/continued employment of certain employees is not an input into a “fixed-for-fixed” valuation model. As a result, the arrangements subject to ASC 815-40 would be required to be classified as a liability and measured at fair value with changes in fair value recorded in current earnings.

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## ***Antidilution features***

Settlement adjustments designed to protect a holder’s position from being diluted by a transaction initiated by an issuer will generally not prevent a freestanding instrument or embedded component from being considered indexed to the issuer’s own stock provided the adjustments are limited to the effect that the dilutive event has on the shares underlying the instrument. Common examples of adjustments that do not preclude a contract from being considered indexed to the issuer’s own stock include the occurrence of a stock split, rights offering, stock dividend, or a spinoff. In addition, settlement adjustments due to issuances of shares for an amount below current fair value, and repurchases of shares for an amount that exceeds the current fair value of those shares, do not preclude the contract from being considered indexed to the issuer’s own stock.

Not all “antidilution” settlement adjustments will meet the criteria for being considered indexed to a reporting entity’s own stock in ASC 815-40-15. Settlement adjustments that overcompensate the holder (i.e., the potential adjustments exceed the potential impact of the dilution) prevent a freestanding instrument or embedded component from being considered indexed to the reporting entity’s own stock.

## ***Down round features***

Some equity-linked financial instruments may contain price protection provisions requiring a reduction in an instrument’s strike price as a result of a subsequent at-market issuance of shares below the instrument’s original strike price, or as a result of the subsequent issuance of another equity-linked instrument with a lower strike price. This is typically referred to as a “down round” feature. Down round features are most often found in warrants and conversion options embedded in debt or preferred equity instruments issued by private entities, but may also be found in financial instruments issued by public companies.

The issuance of shares for an amount equal to the current market price of those shares is not dilutive. Further, the possibility of a market price transaction occurring at a price below an instrument's strike price is not an input to the valuation of a standard "fixed for fixed" instrument. The guidance in ASC 815-10-15-75A effectively makes an exception with respect to down round features to the base model for determining when an instrument or an embedded feature is considered solely indexed to an entity's own stock.

The term "down round" can be applied to provisions with varying terms. As such, a reporting entity should evaluate the specific provision to determine whether it affects the reporting entity's ability to consider an instrument indexed to its own stock.

Adjustment provisions should be evaluated to determine whether they meet the definition of a down round.

The ASC Master Glossary provides the definition of a down round feature.

#### **Definition from ASC Master Glossary**

**Down round feature:** A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

As discussed in ASC 815-10-15-75A, a reporting entity can disregard a down round feature that meets this definition when determining whether the instrument is considered indexed to the reporting entity's own stock. However, when a down round feature is triggered, there are earnings per share implications for certain instruments, as discussed in ASC 260-10-45-12B and FSP 7.4.1.5.

If a feature does not meet the definition of a down round, the instrument must be evaluated under the base model to determine whether it is solely indexed to an entity's own stock.

Example FG 5-12 and Example FG 5-13 illustrate the evaluation of down round features.

#### **EXAMPLE FG 5-12**

##### **Strike price adjustment based on common stock valuation**

Company A, a private company, issues a warrant for the purchase of 100,000 shares of Company A common stock, with a strike price of \$10.00. The warrant provides for net settlement in shares and meets the definition of a derivative under ASC 815. The terms of the warrant state that the strike price of the warrant will be reduced if a subsequent valuation indicates that the fair value of Company A's common stock is below the current strike price. Historically, Company A has prepared a valuation when it issues instruments such as common stock, warrants, and convertible instruments, but it also has had valuations prepared when it issues equity-linked compensation to its employees.



Is the provision regarding the change in the warrant's strike price a down round feature as defined in the guidance?

### *Analysis*

While this feature is similar to a down round feature in that it is designed to protect warrant holders against declines in stock price, the provision does not meet the definition of a down round.

A down round feature contemplates a sale of a company's stock or issuance of an equity-linked financial instrument. If Company A were to obtain or prepare a valuation of its common stock, this could trigger a reset of the instrument's strike price, even if no instrument is issued by Company A. For example, Company A may be contemplating issuing equity to raise capital, but may decide to issue debt based upon the valuation of the common stock. Further, if Company A grants stock options to its employees with vesting requirements, they are not considered issued until they vest under GAAP.

In addition, if Company A were to issue warrants, convertible debt, or convertible preferred stock with a strike price higher than the strike price on the outstanding warrant, but the common stock valuation indicated a common stock price below the outstanding warrant strike price (i.e., Company A issued an out-of-the-money instrument), the strike price on the outstanding warrant would be adjusted downward. This would not be consistent with the definition of a down round, which indicates that the strike price on the outstanding warrant should only be adjusted if the strike price on the issued equity-linked instrument is below the outstanding warrant's strike price.

## **EXAMPLE FG 5-13**

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### *Adjustment to the number of shares*

Company B issues a warrant for the purchase of 100,000 shares of Company B common stock, with a strike price of \$10.00. The warrant provides for net settlement in shares and meets the definition of a derivative under ASC 815. The terms of the warrant provide that when Company B sells common stock below the strike price on the warrant or issues a financial instrument with a strike price below the strike price on the warrant, the warrant will be exercisable into more than the initial 100,000 shares. The strike price of the warrant is not adjusted. This feature is designed to ensure that Company B receives a fixed amount of proceeds upon exercise of the warrant.

Is the provision to adjust the number of shares upon exercise of the warrant a down round feature?

### *Analysis*

Although the definition of a down round refers only to a reduction in strike price, we believe that an increase in shares underlying the warrant can achieve the same economic objective. Therefore, we believe the provision could be considered a down round feature. As a result, it would not, in isolation, cause an instrument to not be considered indexed to an entity's own stock. Increasing the number of shares an instrument is exercisable into is the only practical manner in which a down round can be implemented in a convertible instrument.

Although we believe that an increase in the number of shares underlying a warrant and reducing the strike price achieve the same economic objective, we believe that the increase in the number of shares pursuant to such a provision should not permit a transfer of more value to the holder than a reduction of a strike price would. For example, while the definition of a down round would permit the strike

price of an instrument to be adjusted below the issuance or strike price of the issued instrument, the amount of value that could be transferred by a strike price reduction is limited as the strike price cannot be reduced below zero.

### **5.6.2.3 *Greenshoe (overallotment option) in an equity offering—after adoption of ASU 2020-06***

A greenshoe is a freestanding agreement between a reporting entity and an underwriter that allows the underwriter to require the issuer to issue additional securities to “upsized” the amount of securities issued. These agreements are a mechanism that in part, enables the underwriter to stabilize prices.

There are several types of greenshoes, the most common being an overallotment option. An overallotment option allows the underwriter to call additional securities from the reporting entity only to fill overallotments. The underwriter cannot exercise an overallotment option and hold or sell the securities for its own account. Other types of greenshoes allow the underwriter full discretion over the securities received by exercising their option.

A reporting entity must determine whether the greenshoe meets the requirements of the derivative scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a). Regardless of whether the greenshoe meets the definition of a derivative, reporting entities will need to consider ASC 815-40, and whether the greenshoe is both (1) indexed to the company’s own stock and (2) meets the requirements to be classified in stockholders’ equity in the statement of financial position. If these requirements are met, the greenshoe is classified within equity. If these requirements are not met, the greenshoe must be classified as a liability. A portion of the proceeds received on the issuance of the common stock should be allocated to this written option based on its fair value, if liability classified, or relative fair value, if equity classified. If equity classified, there is no subsequent measurement of the greenshoe. If liability classified, the greenshoe must be recorded at fair value with changes in fair value recorded through earnings.

### **5.6.2.4 *Foreign currency denominated strike price—after adoption of ASU 2020-06***

As discussed in ASC 815-40-15-7I, if an instrument’s strike price is denominated in a currency other than the reporting entity’s functional currency, the instrument is not considered indexed to the reporting entity’s own stock. Whether the shares issuable under the instrument are traded in a market in which transactions are denominated in the same foreign currency is irrelevant to the analysis.

### **5.6.2.5 *Indexed to stock of subsidiary or affiliate—after adoption of ASU 2020-06***

ASC 815-40-15-5C provides guidance on instruments indexed to the shares of a subsidiary.

#### **Excerpt from ASC 815-40-15-5C**

Freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary are not precluded from being considered indexed to the entity’s own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity.

This guidance applies to freestanding instruments and embedded components indexed to the stock of a consolidated subsidiary, whether the instrument is entered into by the parent or the subsidiary. The same is not true for instruments indexed to the stock of an affiliate that is not a consolidated subsidiary or stock of an equity method investee. The stock of such an affiliate or equity method investee is not considered the reporting entity's own stock.

Although not specifically addressed, we believe that the guidance in ASC 815-40 also applies to convertible debt issued by a subsidiary that is convertible into the stock of the parent in the consolidated financial statements of the parent. However, in the separate financial statements of the subsidiary, debt convertible into the parent's stock would generally not be considered indexed to the entity's own stock. See FG 6.4.2.1 for additional information.

### **5.6.3 *Whether instrument meets equity classification requirements—after adoption of ASU 2020-06***

ASC 815-40-25-1 and ASC 815-40-25-2 provide the general framework for determining whether an instrument that is considered indexed to an issuer's own stock should be classified as a liability (or in some cases, an asset) or equity. Application of this guidance requires a detailed understanding of the settlement provisions and other terms of the instrument being analyzed.

A reporting entity is required to perform the analysis to determine whether the requirements for equity classification have been met. Liability classification is not a default classification; thus, a reporting entity cannot forgo the analysis and assume liability classification. In some cases, the evaluation of various contractual terms may be complicated. In such cases, assistance from legal counsel may be required.

#### **ASC 815-40-25-1**

The guidance in this Section applies for the purpose of determining whether an instrument or embedded feature qualifies for the second part of the scope exception in paragraph 815-10-15-74(a). The first part of the scope exception in paragraph 815-10-15-74(a) is addressed in Section 815-40-15. 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 815-40-25-2**

Further, an entity shall observe both of the following:

- a. If the contract provides the counterparty with a choice of net cash settlement or settlement in shares, this Subtopic assumes net cash settlement.
- b. If the contract provides the entity with a choice of net cash settlement or settlement in shares, this Subtopic assumes settlement in shares.

Therefore:

- Contracts that are settled by gross physical delivery of shares or net share settlement may be equity instruments (see FG 5.6.3.1).
- Contracts that require or permit the investor to require a reporting entity to net cash settle are accounted for as assets or liabilities at fair value with changes in fair value recorded in earnings.
- Contracts that a reporting entity could be required to settle in cash should be accounted for as an asset or liability at fair value, regardless of whether net cash settlement would only occur under a remote scenario.

#### **5.6.3.1 Additional requirements for equity classification—after adoption of ASU 2020-06**

It is important to note that not all share-settled contracts qualify for equity classification. For a share-settled contract to be classified as equity, each of the additional conditions in ASC 815-40-25-10 must be met to ensure that the issuer has the ability to settle the contract in shares.

These conditions are intended to identify situations in which net cash settlement could be forced upon the issuer by investors/counterparties or in any other circumstance, regardless of likelihood, except for (1) liquidation of the issuer or (2) a change in control in which the issuer's shareholders also receive cash.

##### **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 815-40-25-9**

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.

##### **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 Exchanges 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.

#### **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 815-40-55-4**

If, instead of cash, holders of the shares underlying the contract receive other forms of consideration (for example, debt), the counterparty also must receive debt (cash in an amount equal to the fair value of the debt would not be considered the same form of consideration as debt).

**ASC 815-40-55-5**

Similarly, a change-in-control provision could specify that if all stockholders receive stock of an acquiring entity upon a change in control, the contract will be indexed to the shares of the purchaser (or issuer in a business combination accounted for as a pooling of interests) specified in the business combination agreement, without affecting classification of 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.

ASC 815-40-25-18 through ASC 815-40-25-30 and ASC 815-40-25-36 through ASC 815-40-25-38 provide further guidance on the requirements for equity classification, including, but not limited to, considerations relating to uneconomic settlement alternatives, determination of whether a reporting entity has sufficient authorized and unissued shares, explicit share limits, and when a net cash payment is required for a contract in a loss position.

ASC 815-40-25-10A provides three conditions that do not have to be considered in an entity's evaluation of net cash settlement. However, reporting entities subject to the guidance in ASC 480-10-S99 should consider whether that guidance would require instruments that could require cash settlement outside of the reporting entity's control to be classified as mezzanine equity. If in scope of ASC 480-10-S99, reporting entities should follow the subsequent measurement guidance therein. Reporting entities seeking to avoid classification as mezzanine equity by analogizing to the exceptions to the evaluation of net cash settlement provided by ASC 815-40-25-10A in the evaluation under ASC 480-10-S99, should pre-clear their proposed accounting and disclosures with the Office of the Chief Accountant of the SEC.

***Sequencing of instruments***

When a reporting entity issues new equity or equity-settled contracts, such as employee stock options, it should assess whether the issuance has an effect on previously issued instruments. The criterion in ASC 815-40-25-10(b) that the issuer have sufficient authorized and unissued shares available to settle all of its contracts may no longer be met. When performing this assessment, a reporting entity should follow the guidance in ASC 815-40-25-20. This guidance requires the evaluation to consider the maximum number of shares that could be required to be delivered during the contract period under existing commitments. The effect of the issuance of new equity-linked or equity-settled instruments on previously issued instruments will depend on the terms of each instrument, as well as the reporting entity's policy for evaluating the sequencing of its instruments (as discussed in Figure FG 5-6) that may be settled in shares.

For example, if a reporting entity issues warrants and concludes that those warrants should be classified as equity, it must have had sufficient authorized and unissued shares to meet the requirements of ASC 815-40-25-10(b) to reach that conclusion. If the reporting entity subsequently issues common stock, and can no longer assert that it has sufficient authorized and unissued shares to satisfy its outstanding warrants, it should determine which warrants should no longer be classified as equity. Figure FG 5-6 illustrates some alternative methods that may be applied; there may be other acceptable methods as well.

**Figure FG 5-6**  
Examples of methods of sequencing instruments

| <b>Methodology</b>         | <b>Description</b>  |
|----------------------------|---|
| Last-in, first-out (LIFO)  | Authorized and unissued shares would first be used to satisfy the most recently issued equity-linked instruments.   |
| First-in, first-out (FIFO) | Authorized and unissued shares would first be used to satisfy the earliest issued equity-linked instruments.  |
| Proportionate              | Authorized and unissued shares would be applied proportionately to all equity linked instruments outstanding. This methodology results in some portion of each equity-linked instrument failing to meet the requirements for equity classification. |

A reporting entity should establish a policy for sequencing instruments and apply that policy consistently.

Example FG 5-14, Example FG 5-15, Example FG 5-16, and Example FG 5-17 illustrate the application of certain additional requirements for equity classification in ASC 815-40-25-10.

### **EXAMPLE FG 5-14**

#### Effect of exchange limits on share issuance

Several stock exchanges in the US (e.g., NYSE and NASDAQ) have rules applicable to companies listed on the exchange that limit the number of shares issuable in an unregistered offering without shareholder approval. The rules generally apply to the issuance of common shares (or an instrument that could be settled in common shares) in excess of 20% of the outstanding common shares of the reporting entity.

FG Corp is registered on the NYSE and has 750,000 authorized shares and 500,000 shares issued and outstanding (and therefore 250,000 shares authorized and unissued).

FG Corp issues an unregistered convertible bond to multiple investors that, upon conversion, will result in the issuance of 125,000 shares (25% of outstanding shares). FG Corp concludes that the embedded conversion option meets the definition of a derivative and must be evaluated to determine whether the scope exception in ASC 815-10-15-74(a) can be applied. FG Corp has not obtained shareholder approval to issue the shares upon conversion of the bond.

Can the conversion option embedded in FG Corp's convertible bond meet the requirements for the scope exception in ASC 815-10-15-74(a)?

*Analysis*

No. If FG Corp's shareholders do not vote to approve the issuance of shares upon conversion of the bond, FG Corp will be prohibited by the NYSE from issuing shares in excess of 20% of its outstanding shares. In that case, upon conversion, the guidance assumes that investors will receive cash equal to the fair value of the share shortfall. Since shareholder approval is not within the control of FG Corp, the possibility of this outcome, however remote, precludes equity classification for any part of the contract that may require cash settlement.

### **EXAMPLE FG 5-15**

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#### **Convertible debt indexed to subsidiary's stock and settleable in stock of parent or subsidiary**

Parent Corp, a public company, has a subsidiary, Sub Inc, which is also a public company and a substantive entity.

Parent Corp has issued convertible debt, which upon conversion can be settled in either Parent Corp or Sub Inc shares at the discretion of Parent Corp. The value that investors will receive (i.e., the conversion value) is indexed solely to the stock price of Sub Inc. The ability to satisfy the conversion value in Parent Corp's shares is merely a settlement mechanism and does not affect the value.

Can the conversion option embedded in Parent Corp's convertible bond meet the requirements for the scope exception in ASC 815-10-15-74(a) for contracts issued or held by the reporting entity that are both (i) indexed to its own stock and (ii) classified in stockholders' equity in its statement of financial position?

*Analysis*

It depends. As discussed in ASC 815-40-15-5C, an instrument issued by a parent indexed to the stock of a consolidated subsidiary should be considered indexed to its own stock provided the subsidiary is a substantive entity. Since Sub Inc is a substantive entity, Parent Corp must determine whether the embedded conversion option meets the requirements to apply the ASC 815-10-15-74(a) scope exception.

The value of the conversion option embedded in Parent Corp's bond is indexed to Sub Inc's shares. Accordingly, it would be considered indexed to Parent Corp's own stock based on the guidance in ASC 815-40-15-5C. The settlement mechanism that allows settlement in shares of either Parent Corp or Sub Inc does not affect this conclusion.

If Parent Corp were required to settle the conversion option in shares of Parent Corp, then the contract would need to be evaluated to determine whether it contained an explicit limit on the number of shares to be delivered in a share settlement. If Sub Inc's share price rose, while Parent Corp's share price fell, then the number of Parent Corp shares required for delivery could increase substantially. Without a maximum cap on the number of Parent Corp shares that Parent Corp could be required to deliver, and if this was the only settlement option alternative, classification of the conversion feature in shareholders' equity would not be permitted. In addition, the potential requirement to issue an unlimited number of Parent Corp shares may have implications for other equity classified



instruments. The criterion in ASC 815-40-25-10(b) that the reporting entity must have sufficient authorized and unissued shares available to settle all of its contracts may no longer be met.

### **EXAMPLE FG 5-16**

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#### **Effect of master netting agreement**

FG Corp issues a convertible bond that, upon conversion, will result in cash settlement of the conversion option.

FG Corp also enters into two contracts with a bank that each meet the definition of a freestanding financial instrument:

- A convertible bond hedge (purchased call option) that mirrors the terms of the embedded conversion option in FG Corp's convertible bond and requires the bank to pay cash to FG Corp equal to the value of the conversion option upon exercise.
- A warrant with a strike price at a 20% premium to the embedded conversion option price that requires FG Corp to deliver net shares to the bank, if the warrant is in the money when the conversion option is exercised.

FG Corp and the bank enter into a master netting agreement that allows the convertible bond hedge and warrant to be netted in determining the amount due in the case of FG Corp's or the bank's bankruptcy.

Can the warrant meet the requirements for equity classification?

#### *Analysis*

No. Since the convertible bond hedge requires cash settlement, the requirements for equity classification are not met. Because upon bankruptcy, the warrant can be netted with a contract that does not meet the requirements for equity classification, the warrant does not meet the requirements for equity classification. The netting agreement effectively provides for net cash settlement of the warrant. Additionally, a master netting agreement is not considered the equivalent of collateral and as such the exception in ASC 815-40-25-10A(c) is not applicable when evaluating the potential for net cash settlement. However, a contract that otherwise met the requirements for equity classification, could be included in a netting arrangement with other contracts that meet the requirements for equity classification without tainting the ability to qualify for equity classification.

### **EXAMPLE FG 5-17**

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#### **Change in control in which the issuer's shareholders receive the same form of consideration**

A company has a single class of common stock and has warrants exercisable for this common stock. Upon exercise, the warrant will be settled on a gross physical basis (the warrant holder will pay the exercise price in cash and receive shares). However, in the event that there is a tender offer as a result of which the purchaser will own more than 50% of the voting stock of the company, the holders can exercise their warrants and receive the same form and amount of consideration received by the common shareholders that participated in the tender offer.

## *Analysis*

Liability classification is generally required when a company could be forced to settle a warrant on a net cash basis (or by delivery of assets) in circumstances outside of its control. However, there is an exception to this model (discussed in ASC 815-40-55-2 through ASC 815-40-55-6) relating to change in control provisions. This guidance states that if the warrant holder receives the same form of consideration as shareholders that participated in the change in control transaction, then equity classification would not be prohibited.

We believe that the tender offer provision in this fact pattern is not inconsistent with the guidance in ASC 815-40 and was not a fact pattern addressed in the SEC's public statement (see FG 5.6.4). Accordingly, equity classification would not be prohibited. However, if the company has multiple classes of common stock, an understanding of the settlement provisions, the scenarios in which they become operable, and the terms of the multiple classes of common stock must be obtained in order to determine if this exception is met. If not met, equity classification is prohibited.

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### **5.6.4 *SEC staff statement on accounting and reporting considerations for warrants issued by SPACs***

The Acting Director of the SEC's Division of Corporate Finance and the SEC's Acting Chief Accountant issued a public statement on April 12, 2021 regarding their recent evaluation of fact patterns relating to the accounting for warrants issued in connection with a SPAC's formation.

One of the key messages in the SEC's public statement on accounting for warrants is if the warrants issued by SPAC entities include any provisions that could change the settlement amount or how the settlement amount is calculated based on who holds the warrants, the warrants would not be considered indexed to an entity's own stock. As a result, the warrants would be classified as liabilities and reported at fair value with changes in fair value reported in current earnings. See Example FG 5-10 (after adoption of ASU 2020-06) for an example of this provision.

In our experience, there are a number of features in warrants that are issued to the founders/sponsors of the SPAC that may cause changes in how the warrant's settlement amount is calculated in the event the founder/sponsor transfers the warrant to a third party. There may also be features in the warrants issued to the public that may involve different settlement terms depending on who holds the warrants. Warrant agreements should be carefully reviewed and any provisions that cause changes in the settlement amount of the warrant or how settlement is calculated, regardless of the significance of such impact, should be evaluated under the SEC's public statement.

Another key message in the SEC's public statement on accounting for warrants relates to tender offer provisions. Liability classification is generally required when a company could be forced to settle a warrant on a net cash basis (or by delivery of assets) in circumstances outside of its control. However, there is an exception to this model (discussed in ASC 815-40-55-2 through ASC 815-40-55-6; see FG 5.6.3.1) relating to change in control provisions. This guidance states that if the warrant holder receives the same form of consideration as shareholders that participated in the change in control transaction, then equity classification would not be prohibited. In the fact pattern from the SEC's public statement, in the event of a tender or exchange offer made to and accepted by holders of more than 50% of the outstanding shares of a single class of common stock, all holders of the warrants would be entitled to receive cash for their warrants, while only certain of the holders of the underlying shares of common stock would be entitled to cash. In the fact pattern presented to the SEC, the tender

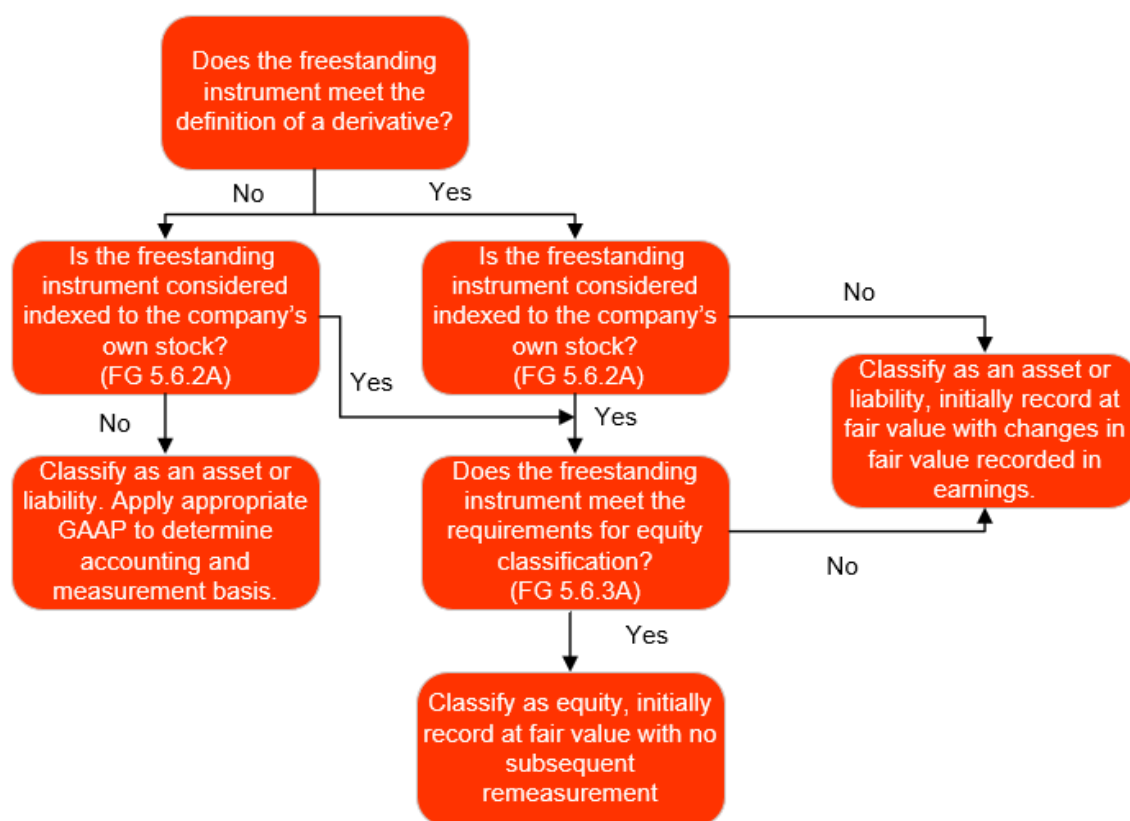
offer did not result in a change in control, as a result, the SEC staff concluded that the tender offer provision would require the warrants to be classified as liabilities and reported at fair value with changes in fair value reported in current earnings. See Example FG 5-17 (after adoption of ASU 2020-06).

## 5.6A Analysis of a freestanding equity-linked instrument—before adoption of ASU 2020-06

Once a reporting entity has determined that a freestanding financial instrument should not be accounted for using the guidance in ASC 480, the next step is to determine whether the instrument should be accounted for as (1) an equity instrument or (2) a liability (or in some cases an asset) under the guidance in ASC 815-40, *Derivatives and Hedging—Contracts in Entity's Own Equity*. Figure FG 5-5A summarizes the steps in the analysis of a freestanding equity-linked instrument.

**Figure FG 5-5A**

Analysis of a freestanding equity-linked instrument



As illustrated in Figure FG 5-5A, the steps used to analyze a freestanding equity-linked instrument differ from the analysis of an embedded equity-linked component. An embedded equity-linked component must meet the definition of a derivative in ASC 815-10-15-83 to be subject to the guidance in ASC 815-40. Consequently, an embedded non-derivative equity-linked component should not be accounted for separately.

A freestanding instrument, on the other hand, does not need to meet the definition of a derivative to be subject to the guidance in ASC 815-40, which may require classification of the instrument as a liability (or in some cases as an asset) measured at fair value. For example, a freestanding warrant on the shares of a private reporting entity may not meet the definition of a derivative because it cannot be net settled and the underlying equity is not readily convertible to cash. However, the instrument should be analyzed to determine whether it would be considered indexed to the reporting entity's own stock and, if so, to determine whether the instrument meets the additional requirements for equity classification. An instrument that is considered indexed to a reporting entity's own stock based on the guidance in ASC 815-40-15 should be evaluated to determine if it meets the requirements for equity classification in ASC 815-40-25; see FG 5.6.3A. If these requirements are also met, equity classification is appropriate, and there is no subsequent remeasurement. If the requirements for equity classification are not met, the instrument should be classified as an asset or liability and recorded at fair value with changes in fair value recorded in the income statement.

If an instrument is not considered indexed to the reporting entity's own stock and does not meet the definition of a derivative, it is required to be classified as an asset or a liability. However, ASC 815-40 does not provide further guidance with respect to the appropriate accounting and measurement basis. The appropriate accounting treatment should be determined by analyzing the terms of the instrument and the nature of the transaction giving rise to its issuance.

See FG 8 for discussion of the model for allocating proceeds and issuance costs to freestanding instruments issued together, such as debt with detachable warrants.

#### **5.6A.1 *Whether the instrument meets the definition of a derivative—before adoption of ASU 2020-06***

ASC 815-10-15-83 provides the definition of a derivative instrument. Many equity derivatives meet two of the three criteria necessary to meet the definition of a derivative: (1) there is an underlying and a notional amount or payment provision, and (2) there is little or no initial net investment. The third criterion, "net settlement," is often the determining criterion.

A freestanding equity-linked instrument meets the net settlement criterion in ASC 815-10-15-83(c)(1) if it can be net share settled, even if the underlying shares are not readily convertible to cash, as illustrated in ASC 815-10-55-90.

#### **ASC 815-10-55-90**

This Example illustrates the concept of net share settlement. Entity A has a warrant to buy 100 shares of the common stock of Entity X at \$10 a share. Entity X is a privately held entity. The warrant provides Entity X with the choice of settling the contract physically (gross 100 shares) or on a net share basis. The stock price increases to \$20 a share. Instead of Entity A paying \$1,000 cash and taking full physical delivery of the 100 shares, the contract is net share settled and Entity A receives 50 shares of stock without having to pay any cash for them. (Net share settlement is sometimes described as a cashless exercise.) The 50 shares are computed as the warrant's \$1,000 fair value upon exercise divided by the \$20 stock price per share at that date.

A freestanding instrument may also meet the net settlement criterion if there is a market that offers a ready opportunity to sell the contract, or if the shares underlying the instrument are readily convertible to cash. See FG 5.4.2 and DH 2.3.5 for further information on the definition of a derivative.

### **5.6A.2 *Whether the instrument is indexed to entity's own stock—before adoption of ASU 2020-06***

The guidance in ASC 815-40-15 requires a reporting entity to apply a two-step approach—it requires the evaluation of an instrument's or embedded component's contingent exercise provisions and then the instrument's or embedded component's settlement provisions. The determination of which step a feature should be analyzed under is critical to the analysis as the evaluation under each step is significantly different.

Before application of the two-step approach to determine whether the instrument is indexed to the entity's own stock, it is important for a reporting entity to understand the unit of account for freestanding contracts or the terms of the embedded derivative being analyzed. For freestanding contracts (that are not embedded in host instruments) judgment is required to determine whether the unit of account should be the overall contract or separate contracts within the overall arrangement. Specifically, a reporting entity must evaluate whether the overall contract represents a single freestanding financial contract or if the overall contract is comprised of a number of separate freestanding financial contracts. See FG 5.3 for further information, including the definition of a freestanding financial instrument. Similarly, judgment is required in determining the terms of the feature being evaluated and whether it consists of a single embedded derivative or multiple embedded derivatives.

ASC 815-40-55-26 through ASC 815-40-55-48 contain a number of examples illustrating the application of the two-step approach to determining whether an instrument is indexed to a reporting entity's own stock.

#### **5.6A.2.1 *Step one—exercise contingencies—before adoption of ASU 2020-06***

Any contingent provision that affects the holder's ability to exercise the instrument or embedded component must be evaluated. For example, holders may have a contingent exercise right or may have their right to exercise accelerated, extended, or eliminated upon satisfaction of a contingency.

ASC 815-40-15-7A and ASC 815-40-15-7B provide guidance on the evaluation of contingent exercise provisions (step 1).

#### **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).

**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).

For example, if a warrant becomes exercisable only if the S&P 500 increases by 10% or the price of oil decreases by 10%, the contingency would fail this step and the warrant would not be considered indexed to the reporting entity's own stock. In contrast, if the warrant became exercisable only if the reporting entity's stock price increased 10%, this step of the guidance would be met, and the analysis would proceed to step two.

Example FG 5-5A and Example FG 5-6A illustrate the application of step one of the indexation guidance.

**EXAMPLE FG 5-5A****Evaluation of exercise contingencies – two potential settlement alternatives**

A company enters into an arrangement to issue shares with the following provisions:

- Three-year maturity
- 1,000 shares will be issued if the volume weighted average price (VWAP) of the company's stock is greater than \$15 for any 20 days within a 30-day trading period

*Analysis*

Since this arrangement provides for only two potential settlement alternatives (either no shares are issued or 1,000 shares are issued), it would be analyzed under step one of the indexation guidance (i.e., it is an exercise contingency). The event that triggers the issuance of a fixed number of shares is based on an observable market price, but it is the price of the company's shares. If the other requirements in ASC 815-40 are met (see FG 5.6.3A), this arrangement may be considered an equity instrument.

**EXAMPLE FG 5-6A****Evaluation of multiple exercise contingencies**

A company enters into an arrangement under which a fixed number of shares will be issued if, during the subsequent three-year period:

- the VWAP of the company's stock is greater than \$15 for any 20 days within a 30-day trading period or
- there is a change in control of the company.

### *Analysis*

Since this arrangement only provides for two potential settlement alternatives (either no shares are issued or a fixed number of shares are issued) it would be analyzed under step one of the indexation guidance (i.e., each alternative is an exercise contingency). In instances when there are multiple contingencies that could cause the issuance of shares, each contingency and the interaction of the contingencies needs to be analyzed. One of the events that triggers the issuance of a fixed number of shares is based on an observable market price, but it is the price of the company's shares. The other event that could trigger the issuance of a fixed number of shares is if there is a change in control, which is not an observable price or an observable index. If the other requirements in ASC 815-40 are met (see FG 5.6.3A), this arrangement may be considered an equity instrument.

#### **5.6A.2.2 Step two—settlement provisions—before adoption of ASU 2020-06**

ASC 815-40-15-7C provides guidance on how to evaluate an instrument's settlement provisions to determine whether the instrument is indexed to the reporting entity's own stock. This guidance is often referred to as the "fixed for fixed" rule.

##### **ASC 815-40-15-7C**

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.

The strike price or the number of shares used to calculate the settlement amount is not considered fixed if the terms of the instrument or embedded component allow for any potential adjustment (except as discussed below), regardless of the probability of the adjustment being made or whether the reporting entity can control the adjustment.

ASC 815-40-15-7E discusses the exception to the "fixed for fixed" rule. This exception allows an instrument to be considered indexed to the reporting entity's own stock even if adjustments to the settlement amount can be made, provided those adjustments are based on standard inputs used to determine the value of a "fixed for fixed" forward or option on equity shares (and the step one analysis 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.

Including other variables, or incorporating a leverage factor that increases the instrument's exposure to the variables in ASC 815-40-15-7E, would preclude the instrument from being considered indexed to the reporting entity's own stock.

Example FG 5-7A through Example FG 5-11A illustrate the application of step two of the indexation guidance.

**EXAMPLE FG 5-7A****Evaluation of an arrangement with multiple potential settlement alternatives**

A company enters into an arrangement to issue shares with the following provisions:

- Three-year maturity
- 100,000 shares will be issued if the VWAP of the company's stock is greater than \$15 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$20 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$25 for any 20 days within a 30-day trading period



*Analysis*

This arrangement provides for multiple settlement alternatives. The contract could result in the issuance of 0, 100,000, 200,000, or 300,000 shares based on whether VWAP exceeds targeted prices. When evaluated under step one of the indexation guidance, in all scenarios, the event that triggers the issuance of shares is based on an observable market price, but it is the price of the company's shares. However, unlike Example FG 5-5A, since there could be a different number of shares issued as a result of the multiple settlement alternatives (i.e. 0, 100,000, 200,000, or 300,000 shares), the arrangement would need to be analyzed under step two of the indexation guidance.

Under step two of the indexation guidance, stock price determines the number of shares to be issued, which is an input into a "fixed-for-fixed" valuation model. If the other requirements in ASC 815-40 are met (see FG 5.6.3A), this arrangement may be considered an equity instrument.

**EXAMPLE FG 5-8A****Evaluation of an arrangement with multiple potential settlement alternatives, including a change in control event**

A company enters into an arrangement under which additional shares will be issued if during the subsequent three-year period, certain thresholds are met, as follows:

- 100,000 shares will be issued if the VWAP of the company's stock is greater than \$15 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$20 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company's stock is greater than \$25 for any 20 days within a 30-day trading period
- 300,000 shares will be issued if there is a change in control of the company

The arrangement meets the definition of a derivative under ASC 815.

*Analysis*

This arrangement provides for multiple settlement alternatives. The contract could result in the issuance of 0, 100,000, 200,000, or 300,000 shares based on whether the VWAP exceeds targeted prices. In addition, if there is a change in control, 300,000 shares are issued. Since there could be a different number of shares issued, it would be analyzed under step two of the indexation guidance.

Stock price impacts the number of shares to be issued, which is an input into a "fixed-for-fixed" valuation model. However, in the event of a change in control, 300,000 shares are issued, which is not an input into a "fixed-for-fixed" valuation model. As a result, this arrangement would be required to be classified as a liability and measured at fair value with changes in fair value recorded in current earnings.

There may be other arrangements similar to Example FG 5-8A with multiple stock price triggers and other triggers that should be analyzed. For example, an instrument that meets the definition of a

derivative under ASC 815 with multiple stock price triggers might also include the following provisions:

- If there is a change in control of the company, and stock price is greater than \$20, then 300,000 shares are issued
- If there is a liquidation of the company, then 300,000 shares are issued
- If there is a change in control of the company, and stock price is greater than \$10, then a pro-rata number of shares between 0 and 100,000 will be issued

Similar to Example FG 5-8A, when analyzed under step two, these fact patterns (when coupled with multiple stock price triggers) will result in the instrument being liability classified and measured at fair value with changes in fair value reported in current earnings because change in control or a liquidation of the company are not inputs into a “fixed-for-fixed” pricing model.

### **EXAMPLE FG 5-9A**

#### **Evaluation of an arrangement to issue shares with multiple settlement alternatives and measures**

A company enters into an arrangement under which additional shares will be issued if during the subsequent three-year period, certain thresholds are met, as follows:

- 100,000 shares will be issued if the VWAP of the company’s stock is greater than \$15 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company’s stock is greater than \$20 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company’s stock is greater than \$25 for any 20 days within a 30-day trading period
- If there is a change in control of the company, the price at which the change in control occurred will be used to determine the number of shares to be issued (based upon the same stock price triggers above) as opposed to the VWAP

The arrangement meets the definition of a derivative under ASC 815.

#### *Analysis*

This arrangement provides for multiple settlement alternatives. The contract could result in the issuance of 0, 100,000, 200,000, or 300,000 shares based on whether the VWAP or the change in control price exceeds targeted prices. For the purposes of this example, the application of step 1 of the indexation guidance is not illustrated. Since there could be a different number of shares issued (0, 100,000, 200,000, or 300,000), it would be analyzed under step two of the indexation guidance.

In evaluating the arrangement under step two, it is important to determine if stock price is the only measure that can determine the number of shares to be issued because stock price is an input into a “fixed-for-fixed” valuation model. If the manner in which the change in control price is determined and VWAP over a short time period are both reasonable means in which to measure the fair value of the company’s stock, the arrangement may be considered indexed to the entity’s own stock.

Assessing whether the change in control price is a reasonable measure of the fair value of the company's stock requires careful consideration of (1) the events considered to be a change in control under the arrangement and (2) the manner in which the change in control price is calculated. For example, many change in control provisions include a company selling substantially all of its assets. If the change in control price calculation does not consider the potential dilutive impact of this arrangement (and potentially other arrangements), it would not be deemed to be a reasonable manner in which to calculate the fair value of the company's stock. If, however, the change in control price calculation considers the potential dilutive impact of this arrangement (and potentially other arrangements), it may be deemed to be a reasonable manner in which to calculate the fair value of the company's stock. Calculations that consider the dilutive impact of the arrangement itself are complex and likely require iterative or simultaneous equation calculations.

If the change in control price calculation is not a reasonable manner in which to calculate the fair value of the company's stock, the arrangement would be required to be classified as a liability and measured at fair value with changes in fair value recorded in current earnings.

If the change in control price calculation is a reasonable manner in which to calculate the fair value of the company's stock and the other requirements in ASC 815-40 are met (see FG 5.6.3A), this arrangement may be considered an equity instrument.

### **EXAMPLE FG 5-10A**

#### **Evaluation of a warrant issued in a SPAC transaction**

A warrant issued in a SPAC transaction exercisable for 1 share of common stock over a five-year term has a strike price of \$11.50 and includes the following provisions:

- In the event that the stock price of the company exceeds \$18, the company can redeem the warrant for \$0.01.
- If the company elects to redeem the warrant, the warrant holder can exercise the warrant.
- The company cannot redeem the warrant while it is held by the sponsor/founder of the SPAC; the company is only able to redeem the warrant if the sponsor/founder transfers the warrant
- In the event that there is a change in control in which shareholders receive a specified form of consideration:
  - the warrant holders will have the ability to exercise their warrants,
  - the exercise price is reduced in an effort to compensate the holders for lost time value of the option (because they would be exercising before the warrant's maturity date - a make-whole provision) based on an option valuation model, and
  - the option valuation model works differently if the warrant is held by the founder/sponsor (not reflecting any ability of the company to redeem the warrants if transferred to a third party) or a third party (reflecting the company's ability to redeem the warrants).

The arrangement meets the definition of a derivative under ASC 815.

## *Analysis*

In this example, the make-whole provision (exercise price reduction) is calculated differently depending on who holds the warrant (the founder/sponsor or a third party). The identity of the holder of the warrant is not an input to a “fixed-for-fixed” valuation model. This warrant would not be considered indexed to a company’s own stock. As a result, this warrant would be required to be classified as a liability and measured at fair value with changes in fair value recorded in current earnings.

In analyzing these features, it is important to understand if the warrant’s settlement amount can be impacted by who holds the warrant. In this example, the warrants issued to sponsors/founders contain provisions that change potential settlement amounts if the warrants are transferred to a third party. However, the SPAC warrants that are held by the public may not contain such features. If the warrants do not have any features that could change the settlement amount or how settlement is calculated, the warrants may be considered indexed to an entity’s own stock.

We understand that this is an example of a provision addressed in the SEC’s public statement (see FG 5.6.5A for additional information).

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There may be other features in a warrant agreement issued in connection with a SPAC that result in changes to settlement amounts or how settlement amounts are calculated depending on who holds the warrant. For example:

- In the event the company elects to redeem certain warrants and the holders exercise their warrants, the settlement amount may be different if the holder is a director or officer of the company.
- Some warrants permit net share settlement upon exercise (frequently referred to as a cashless exercise). In some warrant agreements, the inputs used to calculate the net settlement amount (i.e., shares to be delivered) may be different depending on if the warrant is held by the founder/sponsor or if it is held by a third party. For example, settlement could be based on:
  - the ten day VWAP when held by a sponsor/founder and the average closing price of the stock over a ten-day period when held by another party, or
  - the trailing average of stock price based on the date a warrant is exercised when held by the sponsor/founder and based on the date the warrant is redeemed by the company if held by others.

Based on the guidance in the SEC’s public statement (see FG 5.6.5A), these warrants would not be considered indexed to a company’s own stock because the holder of the warrant can impact the settlement amount and the identity of a holder is not an input into a “fixed for fixed” valuation model. As a result, these warrants would be classified as liabilities and reported at fair value with changes in fair value reported in current earnings.

## EXAMPLE FG 5-11A

### Evaluation of arrangements when the number of shares issuable may increase based on employee behavior (sometimes referred to as a “last person standing provision”)

Arrangements in the company’s stock are issued to investors and employees with vested and unvested stock compensation awards. Assume that additional shares will be issued if during a three-year period, certain thresholds are met, as follows:

- 100,000 shares will be issued if the VWAP of the company’s stock is greater than \$15 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company’s stock is greater than \$20 for any 20 days within a 30-day trading period
- An additional 100,000 shares will be issued if the VWAP of the company’s stock is greater than \$25 for any 20 days within a 30-day trading period

The arrangements issued to employees with unvested options are subject to continued employment vesting requirements (which may be based on the employment vesting requirements in their unvested stock compensation awards). In the event that these arrangements are forfeited by employees, the number of shares that could be issued under these arrangements are “re-allocated” on a pro-rata basis to the other holders. This is sometimes referred to as a “last person standing provision”.

The arrangements meet the definition of a derivative under ASC 815.

#### *Analysis*

The arrangements issued to unvested option holders in this case would be considered compensation and subject to the guidance in ASC 718. See SC 1.3 for further discussion on awards in the scope of ASC 718 as well as SC 2 and SC 3 for measurement and classification considerations. For the arrangements not subject to ASC 718, analysis under ASC 815-40 is required.

These arrangements provide for multiple settlement alternatives. In total the arrangements could result in the issuance of 0, 100,000, 200,000, or 300,000 shares based on whether the VWAP exceeds targeted prices. In addition, the number of shares an individual holder may receive is also based on the continued employment of certain employees that were granted these arrangements. The number of shares an individual holder receives may increase based on the forfeiture of the arrangements granted to employees with unvested options. Since there could be a different number of shares issued depending on certain events, the arrangements would be analyzed under step two of the indexation guidance. For the purposes of this example, the application of step 1 of the indexation guidance is not illustrated.

In evaluating the arrangements under step two, the vesting/continued employment of certain employees is not an input into a “fixed-for-fixed” valuation model. As a result, the arrangements subject to ASC 815-40 would be required to be classified as a liability and measured at fair value with changes in fair value recorded in current earnings.

### ***Antidilution features***

Settlement adjustments designed to protect a holder's position from being diluted by a transaction initiated by an issuer will generally not prevent a freestanding instrument or embedded component from being considered indexed to the issuer's own stock provided the adjustments are limited to the effect that the dilutive event has on the shares underlying the instrument. Common examples of adjustments that do not preclude a contract from being considered indexed to the issuer's own stock include the occurrence of a stock split, rights offering, stock dividend, or a spinoff. In addition, settlement adjustments due to issuances of shares for an amount below current fair value, and repurchases of shares for an amount that exceeds the current fair value of those shares, do not preclude the contract from being considered indexed to the issuer's own stock.

Not all "antidilution" settlement adjustments will meet the criteria for being considered indexed to a reporting entity's own stock in ASC 815-40-15. Settlement adjustments that overcompensate the holder (i.e., the potential adjustments exceed the potential impact of the dilution) prevent a freestanding instrument or embedded component from being considered indexed to the reporting entity's own stock.

### ***Down round features***

Some equity-linked financial instruments may contain price protection provisions requiring a reduction in an instrument's strike price as a result of a subsequent at-market issuance of shares below the instrument's original strike price, or as a result of the subsequent issuance of another equity-linked instrument with a lower strike price. This is typically referred to as a "down round" feature. Down round features are most often found in warrants and conversion options embedded in debt or preferred equity instruments issued by private entities, but may also be found in financial instruments issued by public companies.

The issuance of shares for an amount equal to the current market price of those shares is not dilutive. Further, the possibility of a market price transaction occurring at a price below an instrument's strike price is not an input to the valuation of a standard "fixed for fixed" instrument. The guidance in ASC 815-10-15-75A effectively makes an exception with respect to down round features to the base model for determining when an instrument or an embedded feature is considered solely indexed to an entity's own stock.

The term "down round" can be applied to provisions with varying terms. As such, a reporting entity should evaluate the specific provision to determine whether it affects the reporting entity's ability to consider an instrument indexed to its own stock.

Adjustment provisions should be evaluated to determine whether they meet the definition of a down round.

The ASC Master Glossary provides the definition of a down round feature.

#### **Definition from ASC Master Glossary**

**Down round feature:** A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

As discussed in ASC 815-10-15-75A, a reporting entity can disregard a down round feature that meets this definition when determining whether the instrument is considered indexed to the reporting entity's own stock. However, when a down round feature is triggered, there are earnings per share implications for certain instruments, as discussed in ASC 260-10-45-12B and FSP 7.4.1.5A.

If a feature does not meet the definition of a down round, the instrument must be evaluated under the base model to determine whether it is solely indexed to an entity's own stock.

Example FG 5-12A and Example FG 5-13A illustrate the evaluation of down round features.

### **EXAMPLE FG 5-12A**

#### **Strike price adjustment based on common stock valuation**

Company A, a private company, issues a warrant for the purchase of 100,000 shares of Company A common stock, with a strike price of \$10.00. The warrant provides for net settlement in shares and meets the definition of a derivative under ASC 815. The terms of the warrant state that the strike price of the warrant will be reduced if a subsequent valuation indicates that the fair value of Company A's common stock is below the current strike price. Historically, Company A has prepared a valuation when it issues instruments such as common stock, warrants, and convertible instruments, but it also has had valuations prepared when it issues equity-linked compensation to its employees.

Is the provision regarding the change in the warrant's strike price a down round feature as defined in the guidance?

#### *Analysis*

While this feature is similar to a down round feature in that it is designed to protect warrant holders against declines in stock price, the provision does not meet the definition of a down round.

A down round feature contemplates a sale of a company's stock or issuance of an equity-linked financial instrument. If Company A were to obtain or prepare a valuation of its common stock, this could trigger a reset of the instrument's strike price, even if no instrument is issued by Company A. For example, Company A may be contemplating issuing equity to raise capital, but may decide to issue debt based upon the valuation of the common stock. Further, if Company A grants stock options to its employees with vesting requirements, they are not considered issued until they vest under GAAP.

In addition, if Company A were to issue warrants, convertible debt, or convertible preferred stock with a strike price higher than the strike price on the outstanding warrant, but the common stock valuation indicated a common stock price below the outstanding warrant strike price (i.e., Company A issued an out-of-the-money instrument), the strike price on the outstanding warrant would be adjusted downward. This would not be consistent with the definition of a down round, which indicates that the strike price on the outstanding warrant should only be adjusted if the strike price on the issued equity-linked instrument is below the outstanding warrant's strike price.

## EXAMPLE FG 5-13A

### Adjustment to the number of shares

Company B issues a warrant for the purchase of 100,000 shares of Company B common stock, with a strike price of \$10.00. The warrant provides for net settlement in shares and meets the definition of a derivative under ASC 815. The terms of the warrant provide that when Company B sells common stock below the strike price on the warrant or issues a financial instrument with a strike price below the strike price on the warrant, the warrant will be exercisable into more than the initial 100,000 shares. The strike price of the warrant is not adjusted. This feature is designed to ensure that Company B receives a fixed amount of proceeds upon exercise of the warrant.

Is the provision to adjust the number of shares upon exercise of the warrant a down round feature?

#### *Analysis*

Although the definition of a down round refers only to a reduction in strike price, we believe that an increase in shares underlying the warrant can achieve the same economic objective. Therefore, we believe the provision could be considered a down round feature. As a result, it would not, in isolation, cause an instrument to not be considered indexed to an entity's own stock. Increasing the number of shares an instrument is exercisable into is the only practical manner in which a down round can be implemented in a convertible instrument.

Although we believe that an increase in the number of shares underlying a warrant and reducing the strike price achieve the same economic objective, we believe that the increase in the number of shares pursuant to such a provision should not permit a transfer of more value to the holder than a reduction of a strike price would. For example, while the definition of a down round would permit the strike price of an instrument to be adjusted below the issuance or strike price of the issued instrument, the amount of value that could be transferred by a strike price reduction is limited as the strike price cannot be reduced below zero.

### 5.6A.2.3 ***Greenshoe (overallotment option) in equity offerings—before adoption of ASU 2020-06***

A greenshoe is a freestanding agreement between a reporting entity and an underwriter that allows the underwriter to require the issuer to issue additional securities to “upsized” the amount of securities issued. These agreements are a mechanism that in part, enables the underwriter to stabilize prices.

There are several types of greenshoes, the most common being an overallotment option. An overallotment option allows the underwriter to call additional securities from the reporting entity *only* to fill overallotments. The underwriter cannot exercise an overallotment option and hold or sell the securities for its own account. Other types of greenshoes allow the underwriter full discretion over the securities received by exercising their option.

A reporting entity must determine whether the greenshoe meets the requirements of the derivative scope exception for certain contracts involving a reporting entity's own equity in ASC 815-10-15-74(a). Regardless of whether the greenshoe meets the definition of a derivative, reporting entities will need to consider ASC 815-40, and whether the greenshoe is both (1) indexed to the company's own stock and (2) meets the requirements to be classified in stockholders' equity in the statement of financial position. If these requirements are met, the greenshoe is classified within equity. If these requirements are not met, the greenshoe must be classified as a liability. A portion of the proceeds received on the



issuance of the common stock should be allocated to this written option based on its fair value, if liability classified, or relative fair value, if equity classified. If equity classified, there is no subsequent measurement of the greenshoe. If liability classified and the greenshoe meets the definition of a derivative, the greenshoe must be recorded at fair value with changes in fair value recorded through earnings. If liability classified and the greenshoe does not meet the definition of a derivative, it may also be required to be recorded at fair value with changes in fair value recorded in current earnings under ASC 815-40-35-4. In addition, the greenshoe represents a written call option by the reporting entity on their own stock, in which case reporting entities should consider the SEC's longstanding view on written options, under which the greenshoe would be recorded at fair value, with changes in fair value reported through earnings.

#### **5.6A.2.4 Foreign currency denominated strike price—before adoption of ASU 2020-06**

As discussed in ASC 815-40-15-7I, if an instrument's strike price is denominated in a currency other than the reporting entity's functional currency, the instrument is not considered indexed to the reporting entity's own stock. Whether the shares issuable under the instrument are traded in a market in which transactions are denominated in the same foreign currency is irrelevant to the analysis.

#### **5.6A.2.5 Indexed to stock of subsidiary or affiliate—before adoption of ASU 2020-06**

ASC 815-40-15-5C provides guidance on instruments indexed to the shares of a subsidiary.

##### **Excerpt from ASC 815-40-15-5C**

Freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary are not precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity.

This guidance applies to freestanding instruments and embedded components indexed to the stock of a consolidated subsidiary, whether the instrument is entered into by the parent or the subsidiary. The same is not true for instruments indexed to the stock of an affiliate that is not a consolidated subsidiary or stock of an equity method investee. The stock of such an affiliate or equity method investee is not considered the reporting entity's own stock.

Although not specifically addressed, we believe that the guidance in ASC 815-40 also applies to convertible debt issued by a subsidiary that is convertible into the stock of the parent in the consolidated financial statements of the parent. However, in the separate financial statements of the subsidiary, debt convertible into the parent's stock would generally not be considered indexed to the entity's own stock. See FG 6.4.2.1A for additional information.

#### **5.6A.3 Whether instrument meets equity classification requirements—before adoption of ASU 2020-06**

ASC 815-40-25-1 and ASC 815-40-25-2 provide the general framework for determining whether an instrument that is considered indexed to an issuer's own stock should be classified as a liability (or in some cases, an asset) or equity. Application of this guidance requires a detailed understanding of the settlement provisions and other terms of the instrument being analyzed.

A reporting entity is required to perform the analysis to determine whether the requirements for equity classification have been met. Liability classification is not a default classification; thus, a reporting entity cannot forgo the analysis and assume liability classification. In some cases, the evaluation of various contractual terms may be complicated. In such cases, assistance from legal counsel may be required.

#### **ASC 815-40-25-1**

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 815-40-25-2**

Further, an entity shall observe both of the following:

- a. If the contract provides the counterparty with a choice of net cash settlement or settlement in shares, this Subtopic assumes net cash settlement.
- b. If the contract provides the entity with a choice of net cash settlement or settlement in shares, this Subtopic assumes settlement in shares.

Therefore:

- Contracts that are settled by gross physical delivery of shares or net share settlement may be equity instruments (see FG 5.6.3.1A).
- Contracts that require or permit the investor to require a reporting entity to net cash settle are accounted for as assets or liabilities at fair value with changes in fair value recorded in earnings.
- Contracts that a reporting entity could be required to settle in cash should be accounted for as an asset or liability at fair value, regardless of whether net cash settlement would only occur under a remote scenario.

#### **5.6A.3.1 Additional requirements for equity classification—before adoption of ASU 2020-06**

It is important to note that not all share-settled contracts qualify for equity classification. For a share-settled contract to be classified as equity, each of the additional conditions in ASC 815-40-25-10 must be met to ensure that the issuer has the ability to settle the contract in shares.

These conditions are intended to identify situations in which net cash settlement could be forced upon the issuer by investors/counterparties or in any other circumstance, regardless of likelihood, except for (1) liquidation of the issuer or (2) a change in control in which the issuer's shareholders also receive cash.

**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 815-40-25-9**

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.

**Excerpt from 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,...all of the following conditions must be met for a contract to be classified as equity:

- a. Settlement permitted in unregistered shares. The contract permits the entity to settle in unregistered shares.
- 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 if entity fails to timely file. There are no required cash payments to the counterparty in the event the entity fails to make timely filings with the Securities and Exchanges Commission (SEC).
- e. No cash-settled top-off or make-whole provisions. There are no cash settled top-off or make-whole provisions.
- f. 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.
- g. No collateral required. There is no requirement in the contract to post collateral at any point or for any reason.

**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 815-40-55-4**

If, instead of cash, holders of the shares underlying the contract receive other forms of consideration (for example, debt), the counterparty also must receive debt (cash in an amount equal to the fair value of the debt would not be considered the same form of consideration as debt).

**ASC 815-40-55-5**

Similarly, a change-in-control provision could specify that if all stockholders receive stock of an acquiring entity upon a change in control, the contract will be indexed to the shares of the purchaser (or issuer in a business combination accounted for as a pooling of interests) specified in the business combination agreement, without affecting classification of 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.

ASC 815-40-25-11 through ASC 815-40-25-38 provide further guidance on the requirements for equity classification.

***Sequencing of instruments***

When a reporting entity issues new equity or equity-settled contracts, such as employee stock options, it should assess whether the issuance has an effect on previously issued instruments. The criterion in ASC 815-40-25-10(b) that the issuer have sufficient authorized and unissued shares available to settle all of its contracts may no longer be met. When performing this assessment, a reporting entity should follow the guidance in ASC 815-40-25-20. This guidance requires the evaluation to consider the maximum number of shares that could be required to be delivered during the contract period under existing commitments. The effect of the issuance of new equity-linked or equity-settled instruments on previously issued instruments will depend on the terms of each instrument, as well as the reporting entity's policy for evaluating the sequencing of its instruments (as discussed in Figure FG 5-6A) that may be settled in shares.

For example, if a reporting entity issues warrants and concludes that those warrants should be classified as equity, it must have had sufficient authorized and unissued shares to meet the requirements of ASC 815-40-25-10(b) to reach that conclusion. If the reporting entity subsequently issues common stock, and can no longer assert that it has sufficient authorized and unissued shares to

satisfy its outstanding warrants, it should determine which warrants should no longer be classified as equity. Figure FG 5-6A illustrates some alternative methods that may be applied; there may be other acceptable methods as well.

**Figure FG 5-6A**  
Examples of methods of sequencing instruments

| <b>Methodology</b>         | <b>Description</b>  |
|----------------------------|---|
| Last-in, first-out (LIFO)  | Authorized and unissued shares would first be used to satisfy the most recently issued equity-linked instruments.   |
| First-in, first-out (FIFO) | Authorized and unissued shares would first be used to satisfy the earliest issued equity-linked instruments.  |
| Proportionate              | Authorized and unissued shares would be applied proportionately to all equity linked instruments outstanding. This methodology results in some portion of each equity-linked instrument failing to meet the requirements for equity classification. |

A reporting entity should establish a policy for sequencing instruments and apply that policy consistently.

Example FG 5-14A, Example FG 5-15A, Example FG 5-16A and Example FG 5-17A illustrate the application of certain additional requirements for equity classification in ASC 815-40-25-10.

### **EXAMPLE FG 5-14A**

#### Effect of exchange limits on share issuance

Several stock exchanges in the US (e.g., NYSE and NASDAQ) have rules applicable to companies listed on the exchange that limit the number of shares issuable in an unregistered offering without shareholder approval. The rules generally apply to the issuance of common shares (or an instrument that could be settled in common shares) in excess of 20% of the outstanding common shares of the reporting entity.

FG Corp is registered on the NYSE and has 750,000 authorized shares and 500,000 shares issued and outstanding (and therefore 250,000 shares authorized and unissued).

FG Corp issues an unregistered convertible bond to multiple investors that, upon conversion, will result in the issuance of 125,000 shares (25% of outstanding shares). FG Corp concludes that the embedded conversion option meets the definition of a derivative and must be evaluated to determine whether the scope exception in ASC 815-10-15-74(a) can be applied. FG Corp has not obtained shareholder approval to issue the shares upon conversion of the bond.

Can the conversion option embedded in FG Corp's convertible bond meet the requirements for the scope exception in ASC 815-10-15-74(a)?

*Analysis*

No. If FG Corp's shareholders do not vote to approve the issuance of shares upon conversion of the bond, FG Corp will be prohibited by the NYSE from issuing shares in excess of 20% of its outstanding shares. In that case, upon conversion, the guidance assumes that investors will receive cash equal to the fair value of the share shortfall. Since shareholder approval is not within the control of FG Corp, the possibility of this outcome, however remote, precludes equity classification for any part of the contract that may require cash settlement.

**EXAMPLE FG 5-15A****Convertible debt indexed to subsidiary's stock and settleable in stock of parent or subsidiary**

Parent Corp, a public company, has a subsidiary, Sub Inc, which is also a public company and a substantive entity.

Parent Corp has issued convertible debt, which upon conversion can be settled in either Parent Corp or Sub Inc shares at the discretion of Parent Corp. The value that investors will receive (i.e., the conversion value) is indexed solely to the stock price of Sub Inc. The ability to satisfy the conversion value in Parent Corp's shares is merely a settlement mechanism and does not affect the value.

Can the conversion option embedded in Parent Corp's convertible bond meet the requirements for the scope exception in ASC 815-10-15-74(a) for contracts issued or held by the reporting entity that are both (i) indexed to its own stock and (ii) classified in stockholders' equity in its statement of financial position?

*Analysis*

It depends. As discussed in ASC 815-40-15-5C, an instrument issued by a parent indexed to the stock of a consolidated subsidiary should be considered indexed to its own stock provided the subsidiary is a substantive entity. Since Sub Inc is a substantive entity, Parent Corp must determine whether the embedded conversion option meets the requirements to apply the ASC 815-10-15-74(a) scope exception.

The value of the conversion option embedded in Parent Corp's bond is indexed to Sub Inc's shares. Accordingly, it would be considered indexed to Parent Corp's own stock based on the guidance in ASC 815-40-15-5C. The settlement mechanism that allows settlement in shares of either Parent Corp or Sub Inc does not affect this conclusion.

If Parent Corp were required to settle the conversion option in shares of Parent Corp, then the contract would need to be evaluated to determine whether it contained an explicit limit on the number of shares to be delivered in a share settlement. If Sub Inc's share price rose, while Parent Corp's share price fell, then the number of Parent Corp shares required for delivery could increase substantially. Without a maximum cap on the number of Parent Corp shares that Parent Corp could be required to deliver, and if this was the only settlement option alternative, classification of the conversion feature in shareholders' equity would not be permitted. In addition, the potential requirement to issue an unlimited number of Parent Corp shares may have implications for other equity classified instruments. The criterion in ASC 815-40-25-10(b) that the reporting entity must have sufficient authorized and unissued shares available to settle all of its contracts may no longer be met.

## EXAMPLE FG 5-16A

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### Effect of master netting agreement

FG Corp issues a convertible bond that, upon conversion, will result in cash settlement of the conversion option.

FG Corp also enters into two contracts with a bank that each meet the definition of a freestanding financial instrument:

- A convertible bond hedge (purchased call option) that mirrors the terms of the embedded conversion option in FG Corp's convertible bond and requires the bank to pay cash to FG Corp equal to the value of the conversion option upon exercise.
- A warrant with a strike price at a 20% premium to the embedded conversion option price that requires FG Corp to deliver net shares to the bank, if the warrant is in the money when the conversion option is exercised.

FG Corp and the bank enter into a master netting agreement that allows the convertible bond hedge and warrant to be netted in determining the amount due in the case of FG Corp's or the bank's bankruptcy.

Can the warrant meet the requirements for equity classification?

#### *Analysis*

No. Since the convertible bond hedge requires cash settlement, the requirements for equity classification are not met. Because upon bankruptcy, the warrant can be netted with a contract that does not meet the requirements for equity classification, the warrant does not meet the requirements for equity classification. An arrangement that provides for the netting of contracts that meet the requirements for equity classification with those that do not meet the requirements provides the counterparty with rights that rank higher than those of other shareholders. Additionally, the netting effectively provides for net cash settlement of the warrant.

However, a contract that otherwise met the requirements for equity classification, could be included in a netting arrangement with other contracts that meet the requirements for equity classification without tainting the ability to qualify for equity classification.

## EXAMPLE FG 5-17A

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### Change in control in which the issuer's shareholders receive the same form of consideration

A company has a single class of common stock and has warrants exercisable for this common stock. Upon exercise, the warrant will be settled on a gross physical basis (the warrant holder will pay the exercise price in cash and receive shares). However, in the event that there is a tender offer as a result of which the purchaser will own more than 50% of the voting stock of the company, the holders can exercise their warrants and receive the same form and amount of consideration received by the common shareholders that participated in the tender offer.

## *Analysis*

Liability classification is generally required when a company could be forced to settle a warrant on a net cash basis (or by delivery of assets) in circumstances outside of its control. However, there is an exception to this model (discussed in ASC 815-40-55-2 through ASC 815-40-55-6) relating to change in control provisions. This guidance states that if the warrant holder receives the same form of consideration as shareholders that participated in the change in control transaction, then equity classification would not be prohibited.

We believe that the tender offer provision in this fact pattern is not inconsistent with the guidance in ASC 815-40 and was not a fact pattern addressed in the SEC's public statement (see FG 5.6.5A). Accordingly, equity classification would not be prohibited. However, if the company has multiple classes of common stock, an understanding of the settlement provisions, the scenarios in which they become operable, and the terms of the multiple classes of common stock must be obtained in order to determine if this exception is met. If not met, equity classification is prohibited.

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### **5.6A.4 *Other applicable GAAP—before adoption of ASU 2020-06***

A reporting entity should apply appropriate GAAP for a freestanding equity-linked instrument that does not meet the definition of a derivative and is not considered indexed to the reporting entity's own stock. When the freestanding equity-linked instrument is a written option, and the reporting entity is an SEC registrant, the reporting entity should consider the SEC guidance in ASC 815-10-S99-4.

#### **Excerpt from ASC 815-10-S99-4**

SEC staff's longstanding position is that written options that do not qualify for equity classification initially should be reported at fair value and subsequently marked to fair value through earnings.

### **5.6A.5 *SEC staff statement on accounting and reporting considerations for warrants issued by SPACs***

The Acting Director of the SEC's Division of Corporate Finance and the SEC's Acting Chief Accountant issued a public statement on April 12, 2021 regarding their recent evaluation of fact patterns relating to the accounting for warrants issued in connection with a SPAC's formation.

One of the key messages in the SEC's public statement on accounting for warrants is if the warrants issued by SPAC entities include any provisions that could change the settlement amount or how the settlement amount is calculated based on who holds the warrants, the warrants would not be considered indexed to an entity's own stock. As a result, the warrants would be classified as liabilities and reported at fair value with changes in fair value reported in current earnings. See Example FG 5-10A (before adoption of ASU 2020-06) for an example of this provision.

In our experience, there are a number of features in warrants that are issued to the founders/sponsors of the SPAC that may cause changes in how the warrant's settlement amount is calculated in the event the founder/sponsor transfers the warrant to a third party. There may also be features in the warrants issued to the public that may involve different settlement terms depending on who holds the warrants. Warrant agreements should be carefully reviewed and any provisions that cause changes in the



settlement amount of the warrant or how settlement is calculated, regardless of the significance of such impact, should be evaluated under the SEC's public statement.

Another key message in the SEC's public statement on accounting for warrants relates to tender offer provisions. Liability classification is generally required when a company could be forced to settle a warrant on a net cash basis (or by delivery of assets) in circumstances outside of its control. However, there is an exception to this model (discussed in ASC 815-40-55-2 through ASC 815-40-55-6; see FG 5.6.3.1) relating to change in control provisions. This guidance states that if the warrant holder receives the same form of consideration as shareholders that participated in the change in control transaction, then equity classification would not be prohibited. In the fact pattern from the SEC's public statement, in the event of a tender or exchange offer made to and accepted by holders of more than 50% of the outstanding shares of a single class of common stock, all holders of the warrants would be entitled to receive cash for their warrants, while only certain of the holders of the underlying shares of common stock would be entitled to cash. In the fact pattern presented to the SEC, the tender offer did not result in a change in control, as a result, the SEC staff concluded that the tender offer provision would require the warrants to be classified as liabilities and reported at fair value with changes in fair value reported in current earnings. See Example FG 5-17A (before adoption of ASU 2020-06).

## **5.7 *Reclassification of an instrument—after adoption of ASU 2020-06***

ASC 815-40-35-8 provides guidance on the reassessment of instruments within the scope of ASC 815-40.

### **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.

Although ASC 480 addresses the reclassification of mandatorily redeemable shares, it does not require other liability contracts within its scope to be reassessed. Notwithstanding, we believe these liability contracts should be reassessed and reclassified if circumstances change. For example, if a redemption provision is eliminated from shares underlying a warrant (e.g., no longer redeemable upon an IPO), the reporting entity should assess whether the warrant should be reclassified as equity. See FG 8.2.2.2 for information on warrants on redeemable shares.

ASC 815-40-35-9 and ASC 815-40-35-10 provide guidance on the reclassification of instruments within the scope of ASC 815-40. We believe this guidance should also be applied to contracts within the scope of ASC 480 that are reclassified due to a change in circumstances.

**ASC 815-40-35-9**

If a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the contract during the period the contract was classified as equity shall be accounted for as an adjustment to stockholders' equity. The contract subsequently shall be marked to fair value through earnings. If an embedded feature no longer qualifies for the derivatives scope exception under this Subtopic, the feature shall be separated from its host contract and accounted for as a derivative instrument in accordance with Subtopic 815-10 and Subtopic 815-15 (if all of the criteria in paragraph 815-15-25-1 are met).

**ASC 815-40-35-10**

If a contract is reclassified from an asset or a liability to equity, gains or losses recorded to account for the contract at fair value during the period that the contract was classified as an asset or a liability shall not be reversed. The contract shall be marked to fair value immediately before the reclassification. An embedded derivative that qualifies for the derivatives scope exception upon reassessment under this Subtopic that was separated from its host contract and accounted for as a derivative instrument in accordance with Subtopic 815-10 shall be reclassified to equity. The previously bifurcated embedded derivative shall not be recombined with its host contract.

Reclassification of an instrument may occur when a new equity-linked instrument is issued, and the reporting entity concludes that it does not have sufficient authorized and unissued shares to settle all of its contracts. The determination of which instruments should be classified as equity will depend on the terms and policy for sequencing of instruments as discussed in FG 5.6.3.1.

If an equity-linked instrument classified as a liability is required to be reclassified to equity, the reporting entity should record the change in fair value of the liability through the date of reclassification in the income statement.

## **5.7A *Reclassification of an instrument—before adoption of ASU 2020-06***

ASC 815-40-35-8 provides guidance on the reassessment of instruments within the scope of ASC 815-40.

**ASC 815-40-35-8**

The classification of a contract 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.

Although ASC 480 addresses the reclassification of mandatorily redeemable shares, it does not require other liability contracts within its scope to be reassessed. Notwithstanding, we believe these liability contracts should be reassessed and reclassified if circumstances change. For example, if a redemption provision is eliminated from shares underlying a warrant (e.g., upon an IPO), the reporting entity

should assess whether the warrant should be reclassified as equity. See FG 8.2.2.2 for information on warrants on redeemable shares.

ASC 815-40-35-9 and ASC 815-40-35-10 provide guidance on the reclassification of instruments within the scope of ASC 815-40. We believe this guidance should also be applied to contracts within the scope of ASC 480 that are reclassified due to a change in circumstances.

**ASC 815-40-35-9**

If a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the contract during the period the contract was classified as equity shall be accounted for as an adjustment to stockholders' equity. The contract subsequently shall be marked to fair value through earnings.

**ASC 815-40-35-10**

If a contract is reclassified from an asset or a liability to equity, gains or losses recorded to account for the contract at fair value during the period that the contract was classified as an asset or a liability shall not be reversed.

Reclassification of an instrument may occur when a new equity-linked instrument is issued, and the reporting entity concludes that it does not have sufficient authorized and unissued shares to settle all of its contracts. The determination of which instruments should be classified as equity will depend on the terms and policy for sequencing of instruments as discussed in FG 5.6.3.1A.

If an equity-linked instrument classified as a liability is required to be reclassified to equity, the reporting entity should record the change in fair value of the liability through the date of reclassification in the income statement.

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***Chapter 6:  
Convertible debt—after  
adoption of ASU 2020-06—  
updated December 2022***

## 6.1 Chapter overview of convertible debt accounting—after adoption of ASU 2020-06

This chapter discusses the accounting for convertible debt, including the accounting treatment of modifications, conversion, and extinguishment of convertible debt after the adoption of ASU 2020-06.

Determining the appropriate accounting for convertible debt requires a detailed understanding of the instrument's terms. It will typically require a detailed evaluation of any potential embedded derivatives. Although the accounting literature has been simplified as a result of ASU 2020-06, it can still be difficult to navigate and apply.

### *New guidance*

In August 2020, the FASB issued 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)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the “own stock” scope exception (see FG 5) and certain aspects of the EPS guidance.

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

The guidance in this chapter has been updated to reflect ASU 2020-06 and is thus only applicable after a reporting entity has adopted ASU 2020-06. See FG 6A for convertible debt accounting guidance before the adoption of ASU 2020-06.

## 6.2 Convertible instruments overview—after adoption of ASU 2020-06

Convertible instruments are debt or equity instruments that either require or permit the investor to convert the instrument into equity securities of the issuer. Some convertible instruments are convertible only upon the occurrence of a specified contingent event (e.g., upon an IPO).

An optionally convertible instrument is a debt or equity instrument that the investor has the option to (1) hold to maturity (or in perpetuity if there is no maturity date) and redeem for par value, or (2) exercise the conversion option and receive shares. Convertible instruments are usually settled in the issuer's common shares. If the conversion option is “in the money,” the shares are worth more than the par value of the instrument. Investors typically exercise the conversion option when it is in the

money at (or close to) the instrument's maturity date. Exercising the conversion option at an earlier date causes the investor to forfeit the remaining time value of the conversion option. Rather than early exercising a conversion option, investors looking to exit a convertible instrument often sell it to another investor that will pay for both the intrinsic and time value of the conversion option. If the issuer's common stock price does not reach a level where the conversion option is in the money, the investor may decide not to exercise its option, the instrument will mature, and the investor will receive the par or stated value.

One of the key benefits to convertible instrument issuers is the relatively low cash coupon or dividend when compared to a similar nonconvertible instrument. The reduced interest or dividend rate is a result of the value of the conversion option. In other words, the issuer of a convertible instrument "buys down" the interest rate or dividend by selling the investor the conversion option embedded in the debt or equity host instrument.

Some convertible instruments pay a fixed monetary amount to the investor upon conversion. To do this, the instrument's conversion price is adjusted for increases or decreases in the fair value of the reporting entity's stock. As discussed in ASC 470-20-25-14, such convertible instruments are considered stock-settled debt and are not convertible debt.

See FG 7 for information on the accounting for convertible preferred stock. See FSP 7.5.6 for information on EPS presentation for convertible securities after the adoption of ASU 2020-06. See FSP 12.12.6 for information on disclosures for convertible debt instruments after adoption of ASU 2020-06.

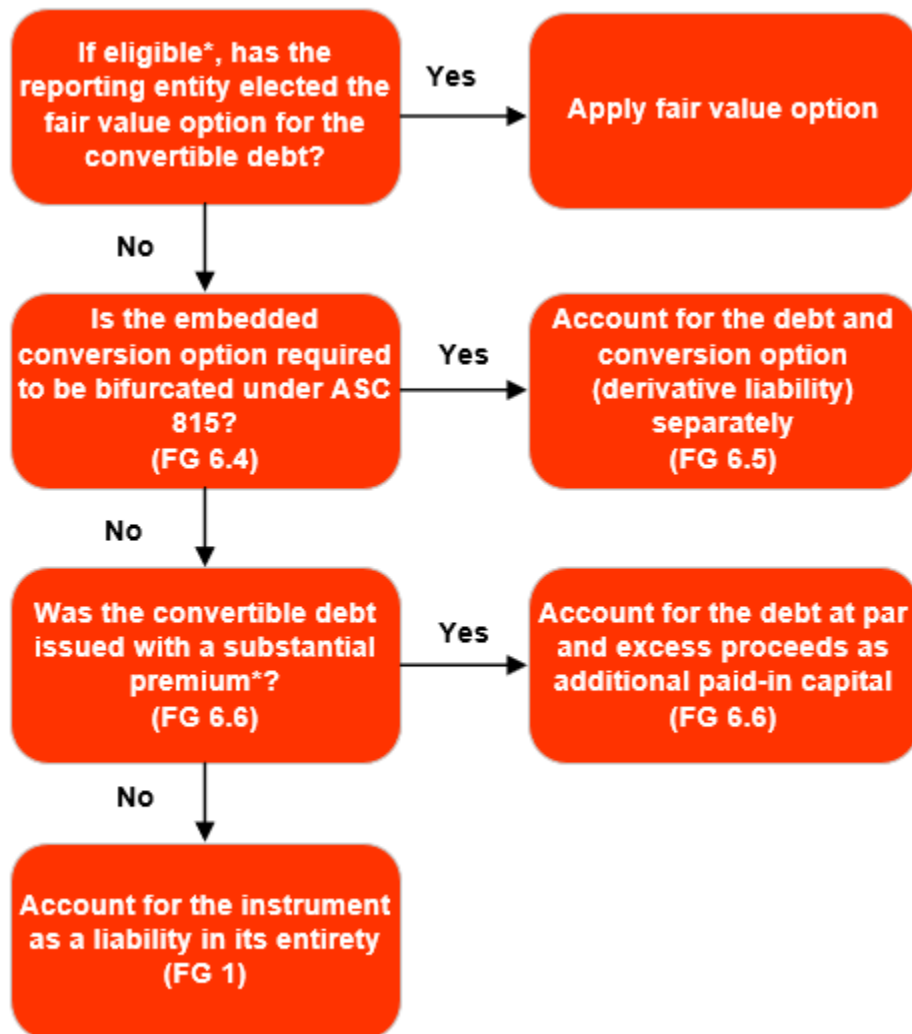
### **6.3 *Analysis of convertible debt—after adoption of ASU 2020-06***

The accounting treatment for a convertible debt instrument depends on the terms of the instrument, including the manner in which the instrument is settled upon conversion. Some convertible debt instruments are settled upon conversion entirely in shares, some in a combination of cash and shares, and, less commonly, entirely in cash. The terms of the convertible debt instrument may mandate a settlement method or the reporting entity (or less commonly the investor) may have a choice.

In addition, many convertible debt instruments contain a number of provisions—such as put and call options or contingent interest features—that should be assessed to determine whether the features should be accounted for separately.

Figure FG 6-1 provides a framework for determining the appropriate accounting for the issuance of convertible debt (ignoring any embedded derivatives other than the conversion option).

**Figure FG 6-1**  
Analysis of convertible debt



\*Convertible debt issued with a substantial premium is not eligible for the fair value option

This framework will help a reporting entity determine which of the three accounting models it should follow when accounting for its convertible debt, assuming the reporting entity is not eligible, or has not elected the fair value option. Each of the three remaining models is summarized in Figure FG 6-2.

**Figure FG 6-2**  
Methods for accounting for convertible debt

| <b>Method</b>                            | <b>Description of methodology</b>   |
|--|---|
| <b>Single instrument</b><br>(FG 1)       | <ul style="list-style-type: none"> <li>□ Record a liability equal to the proceeds received from issuance (assuming no other rights or privileges have been exchanged)</li> <li>□ Amortize any discount or premium in the same manner as nonconvertible debt (see FG 1.2.3)</li> <li>□ Account for an extinguishment of the instrument as discussed in FG 3.7</li> <li>□ Account for a conversion of the instrument as discussed in FG 6.8</li> </ul>  |
| <b>Derivative separation</b><br>(FG 6.5) | <ul style="list-style-type: none"> <li>□ Determine the fair value of the embedded conversion option</li> <li>□ Record the conversion option at fair value and reduce the convertible debt liability by an equivalent amount</li> <li>□ Carry the conversion option as a liability at fair value with changes in fair value recorded in the income statement</li> <li>□ Amortize any discount or premium in the same manner as nonconvertible debt (see FG 1.2.3)</li> <li>□ Account for derecognition as discussed in FG 6.5.1</li> </ul> |
| <b>Substantial premium</b><br>(FG 6.6)   | <ul style="list-style-type: none"> <li>□ Record a liability to reflect the debt at its principal or par amount</li> <li>□ The difference between the proceeds received and the principal or par amount is recorded as additional paid-in capital</li> <li>□ Account for a conversion or an extinguishment as discussed in FG 6.8</li> </ul>   |

Convertible debt instruments issued at a substantial premium that are separated into a debt and an equity component based on the guidance in ASC 470-20, *Debt with Conversion and Other Options*, are not eligible for the fair value option under ASC 825, *Financial Instruments*, based on the guidance in ASC 825-10-15-5(f). ASC 825-10-15-5(f) precludes application of the fair value option to financial instruments that are classified in whole or in part in equity. All other convertible debt instruments may be carried at fair value under the fair value option by the issuer, although this is typically not the case.

## **6.4 Analysis of the embedded conversion option—after adoption of ASU 2020-06**

ASC 815, *Derivatives and Hedging*, provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative.



**ASC 815-15-25-1**

An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of Subtopic 815-10 and this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

This guidance applies to conversion options (and other embedded components such as call and put options or contingent interest) embedded in convertible debt instruments. Many convertible debt instruments contain a conversion option with multiple exercise triggers or contingent events that must occur for a conversion option to become operable. Each exercise trigger may also lead to certain settlement adjustments. These convertible debt instruments are often referred to as “CoCos,” which is shorthand for contingently convertible debt. Some of the more common exercise triggers include (1) a sales price condition, (2) a trading price condition, (3) a notice of redemption, and (4) certain corporate events (e.g., a change of control). Typically, if after performing the analysis of one exercise trigger, it is determined that it should be separately accounted for as a derivative, then the entire conversion option should be separated and accounted for as a single derivative.

**6.4.1 *Clearly and closely related conversion options—after adoption of ASU 2020-06***

When considering whether an embedded equity-linked component is clearly and closely related to its host instrument, a reporting entity should first determine whether the host is an equity host or a debt host. Instruments classified as debt, such as convertible debt instruments, are considered debt hosts. An embedded equity-linked component is generally not considered clearly and closely related to a debt host. See FG 5.4.1 for additional guidance on determining whether a host instrument is more akin to debt or equity.

**6.4.2 *Conversion option—derivative definition—after adoption of ASU 2020-06***

To determine whether a conversion option meets the definition of a derivative, its terms should be evaluated under the guidance in ASC 815-10-15-83. Typically, the criterion that ultimately determines whether or not a conversion option meets the definition of a derivative is the net settlement criterion. If the equity securities underlying the embedded conversion option are readily convertible to cash, such as publicly traded common shares, the embedded conversion option is likely to meet the net settlement criterion to be considered a derivative. If the equity securities underlying the conversion option are not readily convertible to cash, and the conversion option requires gross physical settlement of the underlying shares, the embedded conversion option may not meet the net settlement criterion, and therefore would not meet the definition of a derivative. If the conversion option permits settlement by delivery of net shares (a variable number of shares with a value equal to the intrinsic value of the conversion option) or cash, then it meets the definition of a derivative. See FG 5.4.2 and

DH 2.3.5.3 for further information on the concept of readily convertible to cash and DH 2.3.5 for further information on other forms of net settlement.

If an embedded conversion option meets the definition of a derivative, a reporting entity should assess whether it qualifies for the scope exception for certain contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

#### **6.4.2.1 Conversion option—issuer own equity scope exception—after adoption of ASU 2020-06**

ASC 815-10-15-74(a) provides a scope exception to the derivative accounting required under ASC 815, for certain contracts involving a reporting entity's own equity.

##### **ASC 815-10-15-74(a)**

Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- a. Contracts issued or held by that reporting entity that are both:
  1. Indexed to its own stock (see Section 815-40-15)
  2. Classified in stockholders' equity in its statement of financial position (see Section 815-40-25).

An embedded component is considered indexed to a reporting entity's own stock if it meets the requirements specified in ASC 815-40-15. See FG 5.6.2 for information on those requirements.

##### ***Application to convertible debt***

To apply the requirements for equity classification to a conversion option embedded in a convertible debt instrument, the issuer should first determine whether the convertible debt instrument is one "in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer)" under ASC 815-40-25-39.

If the convertible debt instrument is of this type, the additional requirements for equity classification in ASC 815-40-25-7 through ASC 815-40-25-30 and ASC 815-40-55-2 through ASC 815-40-55-6 are not applicable. As such, solely for the purposes of applying the guidance in ASC 815-10-15-74(a)(2), the reporting entity only needs to consider the stated settlement alternatives (i.e., who controls the settlement and whether the settlement will be in shares or cash) to determine whether the embedded conversion option meets the second requirement for equity classification.

For all other convertible debt instruments, the reporting entity must consider all of the requirements for equity classification in ASC 815-40-25. See FG 5.6.3 for information on those requirements.

## Question FG 6-1

Does a convertible debt instrument that provides for an adjustment to the number of shares deliverable upon conversion via a “make-whole” provision or table (i.e., a provision designed to compensate investors for unanticipated changes to the issuer), as is market standard practice, qualify for the guidance in ASC 815-40-25-39?

### ***PwC response***

No. Generally, an adjustment to the conversion option for anything other than standard anti-dilution provisions (e.g., adjustments for stock splits, rights offerings, dividends, or spin-offs) precludes a convertible debt instrument from qualifying for the guidance in ASC 815-40-25-39. The fact that such a provision is standard practice is not relevant in this analysis.

### ***Application to a contingent conversion option***

A contingent conversion option includes a contingency that determines whether the investor has the right to convert into equity (e.g., convertible only in the event of a successful IPO). To determine whether this type of conversion option should be accounted for separately as a derivative, a reporting entity should consider whether it qualifies for the scope exception for contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

If a conversion option contingency is tied to an event (e.g., an IPO), the contingency may not affect whether the embedded component is considered indexed to the issuer’s stock. If a conversion option contingency is tied to an observable index, the contingency precludes the embedded component from being considered indexed to the issuer’s stock, unless the contingency is based on (1) the issuer’s stock price, or (2) a measure referencing the issuer’s operations (e.g., EBITDA). The reporting entity must also evaluate all of the instrument’s settlement provisions and evaluate the conditions necessary for equity classification.

See FSP 7.5.6.3 for information on earnings per share for contingently exercisable instruments and FSP 12.7 for balance sheet classification considerations applicable to contingently convertible debt.

### ***Application to an adjustment to a conversion option upon a fundamental change***

Many convertible debt instruments provide for an adjustment to the number of shares deliverable if a fundamental change triggers an early conversion. To determine whether this type of conversion option should be accounted for separately as a derivative, a reporting entity should consider whether it qualifies for the scope exception for contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

In accordance with ASC 815-40-15-7D, if the number of shares used to calculate an instrument’s settlement amount is not fixed, it could still be considered indexed to a reporting entity’s own stock if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on equity shares (e.g., strike price, term, stock price volatility).

This provision is typically included primarily to compensate the investor for the time value of the option lost upon an unanticipated change, such as a change in control. Typically, the adjustment to the number of shares is included in a matrix of the issuer’s stock price and time to maturity. The number

of shares to be received upon conversion decreases as the stock price increases and time to maturity decreases. However, because option time value is not linear, neither is the adjustment.

The example in ASC 815-40-55-45 and ASC 815-40-55-46 (excerpted in the following section) concludes that a provision that uses a “make-whole” table to calculate the adjustment to the number of shares delivered upon conversion in the event of a fundamental change should be considered indexed to the reporting entity’s own stock because the number of shares delivered is determined based upon the issuer’s stock price and time to maturity, both of which are inputs to a fair value measurement of a fixed-for-fixed option on equity shares assuming such amount is not unreasonable compensation for lost time value.

In addition, make-whole tables typically include a cap on the number of shares the reporting entity could be required to deliver upon conversion, which addresses one of the requirements for equity classification in ASC 815-40-25. Provided the other requirements for equity classification in ASC 815-40 are met, a conversion option which provides an adjustment (based on the issuer’s stock price and time to maturity) to the number of shares delivered upon conversion in the event of a fundamental change (assuming such adjustment is not unreasonable compensation for lost time value) would meet the requirements for the scope exception for contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

Convertible debt instruments often contain put options that allow investors to put the debt to the issuer (for par or some other stated amount) upon a fundamental change. Depending on the terms, such a put option may comprise both a traditional put right and a contingently exercisable conversion right, as discussed in Question FG 6-2. See FG 1.6.1 for information on evaluating put and call options embedded in debt instruments.

### Question FG 6-2

Should an option that, in the event of a fundamental change, allows an investor to put a convertible debt instrument to the reporting entity for cash equal to the greater of (1) the par value of the debt instrument or (2) the converted value of the debt instrument be separated from the convertible debt instrument?

#### ***PwC response***

The put option upon a fundamental change is really two options (1) a put option at par value and (2) a contingently exercisable conversion option, which must be settled in cash.

The put option at par value needs to be evaluated to determine whether it should be separated (see FG 1.6.1).

The entire embedded conversion option should be separated. A conversion option that must be settled in cash in circumstances beyond the reporting entity’s control is not eligible for the scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a). Although the cash settlement provision is only included in the conversion option exercisable upon a fundamental change, if one settlement alternative fails to qualify for the scope exception, the entire conversion option should be separated and carried at fair value with changes in fair value recorded in the income statement.

***Application to a conversion option with a trading price condition (parity provision)***

Many convertible debt instruments with a contingent conversion option contain a provision that permits the investor to exercise the conversion option if the debt instrument is trading below a specified percentage, for example 98% of the parity value of the underlying shares (referred to as a “parity provision”). This provision is typically included to provide protection to the investor by allowing conversion in a scenario when they may want to convert, but would be unable to do so because other triggers for the contingent conversion (e.g., a stock price trigger) have yet to be met. Theoretically, a convertible debt instrument should be worth more than the underlying shares because a convertible debt instrument provides a floor on the value to be received (absent an event involving the credit of the reporting entity, the investor will receive at least the par value of the debt instrument at maturity) as well as coupon payments over the life of the debt instrument. A parity provision is likely to only be triggered in periods of unusual market disruption that impact the value of the convertible debt instrument and shares.

To determine whether a conversion option with a parity provision should be separated and accounted for as a derivative, a reporting entity should consider whether it qualifies for the scope exception for contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

ASC 815-40-55-45 through ASC 815-40-55-46 analyze the application of the scope exception to an instrument with a market (trading) price trigger, a parity provision, and a merger provision.

**>> Example 19: Variability involving contingently convertible debt with a market price trigger, parity provision, and merger provision****ASC 815-40-55-45**

This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A issues a contingently convertible debt instrument with a par value of \$1,000 that is convertible into 100 shares of its common stock. The convertible debt instrument has a 10-year term and is convertible at any time after any of the following events occurs:

- a. Entity A’s stock price exceeds \$13 per share (market price trigger).
- b. The convertible debt instrument trades for an amount that is less than 98 percent of its if-converted value (parity provision).
- c. There is an announcement of a merger involving Entity A.

**ASC 815-40-55-46**

The terms of the convertible debt instrument also include a make-whole provision. Under that provision, if Entity A is acquired for cash before a specified date, the holder of the convertible debt instrument can convert into a number of shares equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined by reference to a table with axes of stock price and time. That table was designed such that the aggregate fair value of the shares deliverable (that is, the fair value of 100 shares per bond plus the make-whole shares) would be expected to approximate the fair value of the convertible debt instrument at the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the instrument’s inception. The embedded conversion option is considered indexed to Entity A’s own stock based on the following evaluation:

- a. Step 1. The market price trigger and parity provision exercise contingencies are based on observable markets; however, those contingencies relate solely to the market prices of the entity's own stock and its own convertible debt. Also, the merger announcement exercise contingency is not an observable market or an index. Therefore, Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.
- b. Step 2. An acquisition for cash before the specified date is the only circumstance in which the settlement amount will not equal the difference between the fair value of 100 shares and a fixed strike price (\$1,000 fixed par value of the debt). The settlement amount if Entity A is acquired for cash before the specified date is equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a fixed-for-fixed option on equity shares.

As described above, if the requirements for equity classification in ASC 815-40-25 are met, a parity provision typically meets the requirements for the scope exception for contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

#### ***Application to debt convertible into stock of a consolidated subsidiary***

In the consolidated financial statements, debt that is convertible into the stock of a substantive consolidated subsidiary (whether the convertible debt is issued by the parent or the subsidiary) should be accounted for in the same manner as debt that is convertible into the parent company's stock. The same is not true for instruments indexed to the stock of an affiliate that is not a consolidated subsidiary or to the stock of an equity-method investee. The stock of an affiliate or equity-method investee is not considered the reporting entity's own stock.

Although not specifically addressed, we believe that the guidance in ASC 815-40 also applies to convertible debt issued by a subsidiary that is convertible into the stock of the parent in the consolidated financial statements of the parent. However, in the separate financial statements of the subsidiary, debt convertible into the parent's stock would generally not be considered indexed to the entity's own stock.

See FG 5.6.2.4 for information on instruments indexed to the stock of a subsidiary or affiliate.

#### ***Application to instruments convertible into a variable number of shares***

A debt instrument that can be settled by delivery of a variable number of shares should be evaluated to determine whether the embedded conversion option is in substance, a put option (redemption feature) designed to provide the investor with a fixed monetary amount, settleable in shares. For example, a reporting entity may issue a debt instrument that converts, either automatically or at the issuer's option, into a variable number of shares upon the completion of a capital raising transaction. The number of shares received is determined by dividing the instrument's outstanding principal and accrued interest balance by the fair value of the shares (or a specified discount to the fair value of the shares). This feature is in substance a put option, which should be evaluated under the guidance in ASC 815 to determine whether the put option should be separated and accounted for as a derivative. Oftentimes, the formula used to calculate the number of shares to be delivered will result in settlement of the debt instrument at a premium. See FG 1.6.1 for information on evaluating put and call options embedded in debt instruments.

### ***Application to down round features***

As discussed in ASC 815-10-15-75A, a conversion option embedded in a convertible debt instrument that includes a feature that meets the definition of a down round feature in the ASC Master Glossary does not preclude that conversion option from being considered indexed to the entity's own stock.

In addition, convertible debt is exempt from the recognition and measurement provisions in ASC 260-10-25-1, ASC 260-10-30-1 and ASC 260-10-35-1 requiring a reporting entity to record the value of the effect of a down round feature each time it is triggered. The FASB decided to exclude convertible debt from these provisions because ASC 470-20-50-1D requires the issuer of convertible debt that is a public business entity to disclose the fair value of the entire convertible debt instrument and the level of the fair value hierarchy for each convertible debt instrument. The FASB decided that this provides financial statement users with sufficient information because changes in the down round feature should be captured within the fair value measurement.

See FG 5.6.2.2 for further information on antidilution and price protection provisions (including down round features).

## ***6.5 Convertible debt with a separated conversion option—after adoption of ASU 2020-06***

When a reporting entity concludes that a conversion option should be separated from its host debt instrument and accounted for as a derivative, it should be accounted for as a freestanding derivative instrument under the guidance in ASC 815. That is, classified on the balance sheet as a derivative liability at fair value with any changes in its fair value recognized currently in the income statement. The host contract should be accounted for using the guidance applicable to nonconvertible debt.

ASC 815-15-30-2 through ASC 815-15-30-6 provide guidance on allocating the carrying amount of a hybrid instrument between the host contract and the derivative. That guidance requires the derivative to be initially measured at fair value, with the host contract carried at a value equal to the difference between the previous carrying amount of the hybrid instrument and the fair value of the derivative. Therefore, there is no gain or loss from the initial recognition and measurement of an embedded derivative that is accounted for separately from its host contract, except in the rare cases discussed in FG 5.4.5 when the fair value of the bifurcated derivative exceeds the net proceeds received. When the embedded derivative is an option, ASC 815-15-30-6 requires it to be separated and recorded at its fair value based on its stated contract terms. The allocation of proceeds to the separated derivative will typically create a discount or premium on the associated host debt instrument.

The embedded derivative should be reassessed each reporting period to determine whether the embedded component subsequently meets the own stock scope exception. See FG 6.5.2 for information on the reclassification of previously separated conversion options.

### ***6.5.1 Derecognition of debt with separated conversion option—after adoption of ASU 2020-06***

When a conversion feature has been separated from a convertible debt instrument and accounted for as a derivative liability, there is no equity conversion feature remaining in the debt for accounting purposes. Therefore, while there may be a legal conversion of the debt, for accounting purposes we believe that both liabilities (i.e., the debt host and the separated derivative liability) should be subject

to extinguishment accounting, because they are being surrendered in exchange for common shares. As such, a gain or loss upon extinguishment of the two liabilities equal to the difference between the recorded value of the liabilities and the fair value of the consideration issued to extinguish them should be recorded.

To account for the conversion of a convertible instrument when the conversion option has been separated and accounted for as a derivative liability, a reporting entity should perform the following steps:

- Update the valuation of the separated conversion option to the date the instrument is legally converted
- Adjust the carrying amount of the host debt instrument to reflect amortization of any premium or discount associated with the host debt instrument up to the date the instrument is legally converted
- Amortize debt issuance costs to the date the instrument is legally converted
- Ensure that the carrying amount of the host debt instrument reflects all components of book value, including the unamortized portion of any premiums or discounts on the debt host recorded as an adjustment to the debt host and any unamortized debt issuance costs, and accrued interest. These items collectively represent the net carrying amount of the debt host used to measure the extinguishment gain or loss
- Calculate the difference between the reacquisition price and the net carrying amount of the debt by comparing the fair value of the consideration (i.e., cash and shares) issued upon conversion to the sum of the updated net carrying amounts of the (1) separated conversion option liability and (2) debt host. Record any difference as an extinguishment gain or loss in the income statement

When updating the valuation of the separated conversion option to the date the instrument is legally converted, reporting entities may adjust the separated conversion option to either its intrinsic value or fair value as of the conversion date. Adjusting the separated conversion option to its intrinsic value reflects the investor's decision to truncate the term of the option by exercising it early. The foregone time value is recorded as part of the change in fair value of the derivative liability recorded in the income statement, but not as part of the extinguishment transaction. Adjusting the separated conversion option to its fair value allocates the time value foregone by the investor to the gain or loss on extinguishment, rather than the change in the fair value of the derivative liability. Under either approach, the total income statement impact is the same.

Example FG 6-1 illustrates how to account for the derecognition of a convertible debt instrument with a separated conversion option.

### **EXAMPLE FG 6-1**

#### **Derecognition of convertible debt with a separated conversion option**

FG Corp issues convertible debt that is required to be settled upon conversion entirely in cash. FG Corp concludes that the embedded conversion option should be separated from the debt and accounted for as a derivative liability under the guidance in ASC 815. The host debt instrument is accounted for as a liability.



FG Corp determines the fair value of the embedded conversion option to be \$200.

FG Corp's stock price is \$85 at the date the convertible debt is issued. The debt is issued at par and for this example, there are no debt issuance costs.

The convertible debt has the following terms:

|   |  |
|---|--|
| Principal amount                              | \$1,000  |
| Coupon rate                                   | 5% paid semi-annually on June 30 and December 31 |
| Years to maturity                             | 5 years  |
| Conversion price                              | \$100  |
| Number of shares underlying conversion option | 10   |

One year after FG Corp issues the convertible debt, investors exercise their conversion options when the stock price is \$110. FG Corp delivers \$1,100 in cash (\$110 current stock price multiplied by 10 shares underlying the conversion option) to investors.

The fair value of the embedded conversion option is \$380 at the conversion date, one year after issuance and prior to exercise.

This example ignores the effects of accrued interest and income taxes for simplicity.

How should FG Corp record (1) issuance of the convertible debt and (2) conversion of the convertible debt?

### *Analysis*

To recognize the conversion option (at fair value of \$200) and the debt host contract (remaining proceeds) upon issuance of the convertible debt, FG Corp should record the following journal entry.

|   |         |       |
|---|---------|-------|
| Dr. Cash  | \$1,000 |       |
| Cr. Debt host instrument                                  |         | \$800 |
| Cr. Derivative liability<br>(separated conversion option) |         | \$200 |

At the end of the first year, FG Corp should (1) update the valuation of the separated conversion option to its fair value of \$380 and (2) amortize the debt discount by recording the following journal entry.

|   |       |       |
|---|-------|-------|
| Dr. Loss on derivative liability                          | \$180 |       |
| Dr. Interest expense<br>(amortization of discount)        | \$32  |       |
| Cr. Debt host instrument                                  |       | \$32  |
| Cr. Derivative liability<br>(separated conversion option) |       | \$180 |

To derecognize the host debt instrument and separated conversion option upon conversion, FG Corp should record the following entries.

First, FG Corp should adjust the value of the separated conversion option. Management elects to adjust the value to its intrinsic value of \$100 at the conversion date (stock price of \$110 less the conversion price of \$100 multiplied by 10 shares). As noted above, adjusting the separated conversion option to its fair value would also have been acceptable.

|   |       |       |
|---|-------|-------|
| Dr. Derivative liability<br>(separated conversion option) | \$280 |       |
| Cr. Gain on derivative liability                          |       | \$280 |

Next, FG Corp should extinguish the debt host instrument and derivative liability and recognize a loss on extinguishment.

|   |       |         |
|---|-------|---------|
| Dr. Debt host instrument                                  | \$832 |         |
| Dr. Derivative liability<br>(separated conversion option) | \$100 |         |
| Dr. Loss on debt extinguishment                           | \$168 |         |
| Cr. Cash  |       | \$1,100 |

### 6.5.2 ***Reclassification of separated conversion option after adoption of ASU 2020-06***

ASC 815-15-35-4 provides guidance that addresses a reporting entity's accounting for a previously separated conversion option that no longer meets the criteria for separate accounting.

#### **ASC 815-15-35-4**

If an embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in this Subtopic, an issuer shall account for the previously bifurcated conversion option by reclassifying the carrying amount of the liability for the conversion option (that is, its fair value on the date of reclassification) to shareholders' equity. Any debt discount recognized when the conversion option was bifurcated from the convertible debt instrument shall continue to be amortized.

ASC 815-15-50-3 requires a reporting entity to disclose (1) a description of the principal changes causing the embedded conversion option to no longer require separate accounting and (2) the amount of the liability for the conversion option reclassified to stockholder's equity.

ASC 815-15-40-1 and ASC 815-15-40-4 address a reporting entity's accounting upon conversion or extinguishment, respectively, of an instrument which has previously been separated. When a convertible debt instrument with a previously separated conversion option that has been reclassified to equity converts pursuant to the instrument's original conversion terms, a reporting entity should first apply the guidance in ASC 815-15-40-1 and then account for the conversion in accordance with ASC 470-20-40-4, as discussed in FG 6.8. We believe that when a convertible debt instrument with a previously separated conversion option that has been reclassified to equity is not converted in accordance with its original conversion terms, a reporting entity should apply the extinguishment accounting required by ASC 815-15-40-4 (unless the specialized accounting for induced conversions applies). See FG 6.8.2 for more information on induced conversions.

#### **ASC 815-15-40-1**

If a holder exercises a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to paragraph 815-15-35-4, the issuer shall recognize any unamortized discount remaining at the date of conversion immediately as interest expense.

#### **ASC 815-15-40-4**

If a convertible debt instrument with a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to the guidance in paragraph 815-15-35-4 is extinguished for cash (or other assets) before its stated maturity date, the entity shall do both of the following:

- a. The portion of the reacquisition price equal to the fair value of the conversion option at the date of the extinguishment shall be allocated to equity.
- b. The remaining reacquisition price shall be allocated to the extinguishment of the debt to determine the amount of gain or loss.

## **6.6 *Convertible debt with a substantial premium—after adoption of ASU 2020-06***

When a reporting entity concludes that a conversion option should not be separated from its host debt instrument under ASC 815, it should further evaluate whether the convertible debt was issued with a substantial premium. The Codification does not define substantial premium. Some may consider a premium equal to or greater than 10% of the par value of the host debt instrument to be substantial. However, a 10% premium is not a bright line; all relevant facts and circumstances should be considered to determine whether the premium is substantial. For example, if the premium is less than 10%, but the amortization of the premium would result in negative interest expense, the premium may still be considered substantial.

If a reporting entity concludes the convertible debt instrument was issued at a substantial premium, there is a presumption that the premium represents paid-in capital. In these cases, the convertible

debt is reported by recording a liability at its principal or par amounts, and the excess proceeds are reported as additional paid-in capital.

ASC 470-20-25-13 addresses a reporting entity's accounting upon issuance of a convertible debt instrument at a substantial premium.

### **ASC 470-20-25-13**

If a convertible debt instrument is issued at a substantial premium, there is a presumption that such premium represents paid-in capital.

The portion of the proceeds of the convertible debt issuance classified as additional paid-in capital should not be subsequently remeasured. While there is no explicit guidance related to the conversion accounting for convertible debt issued at a substantial premium, we believe the guidance in ASC 470-20-40-4 should be applied, and no gain or loss should be recognized upon conversion. See FG 6.8 for further information on conversion accounting. There is also no explicit guidance related to the extinguishment of convertible debt issued at a substantial premium. We believe that when convertible debt issued at a substantial premium is extinguished (i.e., settled in a manner other than converting pursuant to its terms, but not an induced conversion), that the fair value of the consideration transferred should first be allocated to additional paid in capital based on the amount originally recorded in additional paid in capital, with the remaining consideration allocated to the reacquisition of the debt. The measurement of the gain or loss on the extinguishment of the debt should be calculated in accordance with ASC 470-50-40-2. See FG 3.7.

Example FG 6-2 illustrates how to account for the extinguishment of a convertible debt instrument with a substantial premium at issuance.

### **EXAMPLE FG 6-2**

#### **Extinguishment of convertible debt with a substantial premium at issuance**

FG Corp issues convertible debt on January 1, 20X1 with a par amount of \$1,000, an annual coupon rate of 3% and a maturity date of December 31, 20X5. The conversion feature is exercisable at any time and must be fully settled in shares (par value of \$1 per share). The conversion feature is not required to be bifurcated pursuant to ASC 815, and there are no other embedded features in the convertible debt. The conversion price is \$10, and FG Corp received proceeds of \$1,150 in cash.

FG Corp applies the substantial premium model to the convertible debt and recorded the following entries on January 1, 20X1:

|                                |         |         |
|--------------------------------|---------|---------|
| Dr. Cash                       | \$1,150 |         |
| Cr. Debt                       |         | \$1,000 |
| Cr. Additional paid-in capital |         | \$150   |

On December 31, 20X3, FG Corp redeems the convertible debt by paying \$1,200 in cash to the convertible debt holder.

How should FG Corp account for the extinguishment?

*Analysis*

As the original conversion terms required share settlement in full, and the extinguishment was completed entirely in cash, induced conversion accounting would not apply since the settlement does not include the issuance of all equity securities pursuant to original terms.

FG Corp would apply extinguishment accounting under ASC 470-50-40-2 after allocating consideration paid to the amount initially recorded in APIC.

To account for the extinguishment, FG Corp would first allocate the consideration paid (\$1,200) to the substantial premium originally recorded in APIC (\$150). The remaining consideration would be attributed to the extinguishment of the debt. Consistent with the guidance in ASC 470-50-40-2, any difference between the reacquisition price of the debt and the net carrying amount of the debt would be recognized in income. The remaining consideration of \$1,050 would be compared to the carrying value of the recorded liability (\$1,000) resulting in the recognition of a \$50 extinguishment loss. The following entry would be recorded:

|                                |         |         |
|--------------------------------|---------|---------|
| Dr. Convertible debt liability | \$1,000 |         |
| Dr. APIC                       | \$150   |         |
| Dr. Debt extinguishment loss   | \$50    |         |
| Cr. Cash                       |         | \$1,200 |

---

Convertible debt instruments that are separated into a debt and equity component in accordance with the guidance in ASC 470-20-25-13 are not eligible for the fair value option under ASC 825, based on the guidance in ASC 825-10-15-5(f). ASC 825-10-15-5(f) precludes application of the fair value option to financial instruments that are, in whole or in part, classified in equity by a reporting entity.

## **6.7 Modification of convertible debt—after adoption of ASU 2020-06**

For convertible debt, the test to determine whether a debt modification or extinguishment has occurred is more complicated than the 10% test described in FG 3.4.

ASC 470-50-40-10 prescribes a two-step approach for determining whether a convertible debt modification should be accounted for as a modification or an extinguishment.

### **ASC 470-50-40-10**

From the debtor's perspective, an exchange of debt instruments between or a modification of a debt instrument by a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. If the terms of a debt instrument are changed or modified and the cash flow effect on a present value basis is less than 10 percent, the debt instruments are not considered to be substantially different, except in the following two circumstances:

- a. A modification or an exchange affects the terms of an embedded conversion option, from which the change in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is at least 10 percent of the carrying amount of the original debt instrument immediately before the modification or exchange.
- b. A modification or an exchange of debt instruments adds a substantive conversion option or eliminates a conversion option that was substantive at the date of the modification or exchange. (For purposes of evaluating whether an embedded conversion option was substantive on the date it was added to or eliminated from a debt instrument, see paragraphs 470-20-40-7 through 40-9.)

ASC 470-50-40-10 does not address legal modifications or exchanges of debt instruments in which the embedded conversion option is separated and accounted for as a derivative under ASC 815 prior to modification, subsequent to modification, or both. The accounting for these transactions depends on the specific facts and circumstances.

### **6.7.1 Analysis of modifications and exchanges—after adoption of ASU 2020-06**

To determine whether a modification or exchange of a convertible debt instrument (when the conversion option has not been bifurcated from the host) should be accounted for as a modification or an extinguishment, a reporting entity should perform a two-step analysis.

#### **6.7.1.1 Step 1: evaluate the change in cash flows—after adoption of ASU 2020-06**

The first step a reporting entity should perform is the 10% test discussed in FG 3.4. The 10% test should not include any changes in fair value of the embedded conversion option.

If there is an extinguishment under Step 1, there is no need to conduct the additional tests in Step 2. However, if Step 1 does not indicate an extinguishment, the reporting entity should proceed to the tests in Step 2 to determine if extinguishment accounting is required.

#### **6.7.1.2 Step 2: evaluate the change in the conversion option—after adoption of ASU 2020-06**

If the change in the fair value of the embedded conversion option is greater than 10% of the carrying amount of the original debt instrument immediately before the modification, the modification should be accounted for as an extinguishment. The fair value of the embedded conversion option is generally calculated using an option pricing model, such as the Black-Scholes-Merton model, based on the terms of the embedded conversion option and inputs such as market interest rates, the reporting entity's stock price, the volatility of the reporting entity's stock price, and the expected dividend yield on the reporting entity's stock.

If the modification adds or removes a substantive conversion option from the original debt instrument, the modification should be accounted for as an extinguishment.

See FG 3.7 for information on debt extinguishment accounting.

### 6.7.2 **Convertible debt modification accounting—after adoption of ASU 2020-06**

As described in ASC 470-50-40-15, when a convertible debt instrument is modified or exchanged in a transaction that is not accounted for as an extinguishment, an increase in the fair value of the embedded, unseparated conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) should reduce the carrying amount of the convertible debt instrument (increasing debt discount or reducing debt premium) with a corresponding increase in additional paid-in capital. This additional discount should be amortized over the remaining term of the convertible debt. However, a decrease in the fair value of an embedded conversion option resulting from a modification should not be recognized.

The reporting entity should reassess the convertible debt to determine whether the embedded conversion option should be separated and accounted for as a derivative under the guidance in ASC 815.

## 6.8 **Conversion accounting—after adoption of ASU 2020-06**

If a convertible debt instrument (where the conversion option was not bifurcated) is converted into a reporting entity's common or preferred stock pursuant to the terms of a conversion option in the instrument, it is not an extinguishment; the convertible debt is settled in exchange for equity and no gain or loss is recognized upon conversion. Conversely, the exchange of common or preferred stock for debt that does *not* contain a conversion right in its original terms or does not occur pursuant to the terms of a conversion option is an extinguishment (unless it is considered an induced conversion). Such an exchange may also be considered a troubled debt restructuring. See FG 3.3 for information on troubled debt restructurings.

ASC 470-20-40-4 provides guidance on accounting for conversions consistent with the original terms of a convertible debt instrument accounted for as a liability in its entirety.

### **ASC 470-20-40-4**

If a convertible debt instrument accounted for in its entirety as a liability under paragraph 470-20-25-12 is converted into shares, cash (or other assets), or any combination of shares and cash (or other assets), in accordance with the conversion privileges provided in the terms of the instrument, upon conversion the carrying amount of the convertible debt instrument, including any unamortized premium, discount, or issuance costs, shall be reduced by, if any, the cash (or other assets) transferred and then shall be recognized in the capital accounts to reflect the shares issued and no gain or loss is recognized.

We believe debt issuance costs should be treated similar to debt discount or premium; therefore, we believe the carrying amount should include unamortized debt issuance costs. Interest expense should be accrued (or imputed, in the case of a zero coupon convertible debt instrument) up to the date of conversion. If the accrued interest is not paid in cash upon conversion, then it should also be included in the carrying amount of the debt upon conversion. Interest is accrued at the pre-tax amount.

Generally, conversion accounting is only appropriate when the conversion option has not been separated from the debt and accounted for as a derivative based on the guidance in ASC 815.

Example FG 6-3 illustrates conversion accounting when convertible debt is accounted for entirely as a liability and settled upon conversion entirely in shares.

**EXAMPLE FG 6-3**

**Conversion accounting when convertible debt is accounted for entirely as a liability and settled entirely in shares**

FG Corp issues convertible debt that will be settled upon conversion entirely in shares, and concludes that the convertible debt should be accounted for as a liability in its entirety.

Debt issuance costs are \$30 and are recorded as additional debt discount on the balance sheet.

FG Corp’s stock price is \$20 at the date the convertible debt is issued. FG’s common stock has a par value of \$1 per share. The debt is issued at par.

The convertible debt has the following terms:

|                   |  |
|-------------------|--|
| Principal amount  | \$1,000  |
| Coupon rate       | 5% paid semi-annually on June 30 and December 31 |
| Years to maturity | 5 years  |
| Conversion price  | \$25   |

Two years after FG Corp issues the debt, investors exercise their conversion options. FG Corp’s stock price is \$35 at the conversion date. FG Corp has amortized \$11 of debt issuance costs by the conversion date; therefore, there are \$19 of unamortized debt issuance costs.

This example ignores the effects of accrued interest and income taxes for simplicity.

How should FG Corp record the conversion of its convertible debt?

*Analysis*

To derecognize the convertible debt and unamortized debt issuance costs, and recognize the common stock issued upon conversion, FG Corp should record the following entry.

|                                  |         |       |
|----------------------------------|---------|-------|
| Dr. Convertible debt             | \$1,000 |       |
| Cr. Deferred debt issuance costs |         | \$19  |
| Cr. Common stock – par value     |         | \$40  |
| Cr. Additional paid-in capital   |         | \$941 |

Example FG 6-4 illustrates conversion accounting when convertible debt is accounted for entirely as a liability. Upon conversion the principal amount is settled in cash and the conversion spread in shares.



**EXAMPLE FG 6-4**

Conversion accounting when convertible debt is accounted for entirely as a liability with principal amount settled in cash and the remainder in shares.

FG Corp issues convertible debt that will be settled upon conversion with the principal amount paid in cash and the conversion spread in shares. Any fractional shares will be settled in cash. FG Corp concludes that the convertible debt should be accounted for as a liability in its entirety.

Debt issuance costs are \$30 and are recorded as additional debt discount on the balance sheet.

FG Corp's stock price is \$20 at the date the convertible debt is issued. FG's common stock has a par value of \$1 per share. The debt is issued at par.

The convertible debt has the following terms:

|                   |  |
|-------------------|--|
| Principal amount  | \$1,000  |
| Coupon rate       | 5% paid semi-annually on June 30 and December 31 |
| Years to maturity | 5 years  |
| Conversion price  | \$25   |

Two years after FG Corp issues the debt, investors exercise their conversion options. FG Corp's stock price is \$35 at the conversion date. FG Corp has amortized \$11 of debt issuance costs through the conversion date; therefore, there are \$19 of unamortized debt issuance costs.

The shares to be issued are 11.43 ( $\$400$  conversion spread intrinsic value /  $\$35$  stock price at conversion). FG Corp will issue 11 shares and pay \$15 ( $\$35$  stock price at conversion \* 0.43 shares) in lieu of issuing fractional shares.

This example ignores the effects of accrued interest and income taxes for simplicity.

How should FG Corp record the conversion of its convertible debt?

*Analysis*

To derecognize the convertible debt and unamortized debt issuance costs, and recognize cash paid for the principal amount and fractional shares upon conversion, FG Corp should record the following entry.

|                                  |         |         |
|----------------------------------|---------|---------|
| Dr. Convertible debt             | \$1,000 |         |
| Dr. Additional paid-in capital   | \$34    |         |
| Cr. Deferred debt issuance costs |         | \$19    |
| Cr. Cash                         |         | \$1,015 |

To recognize common stock issued upon conversion, FG Corp should record the following entry.

|                                |      |      |
|--------------------------------|------|------|
| Dr. Additional paid-in capital | \$11 |      |
| Cr. Common stock – par value   |      | \$11 |

---

Example FG 6-5 illustrates conversion accounting when convertible debt is accounted for entirely as a liability and upon conversion, the issuer elects to settle entirely in cash.

**EXAMPLE FG 6-5**

Conversion accounting when convertible debt is accounted for entirely as a liability. Upon conversion the issuer elects to settle the conversion entirely in cash.

FG Corp issues convertible debt and concludes that it should be accounted for as a liability in its entirety. Upon conversion, the issuer elects to settle the instrument entirely in cash (which is specifically permitted by the contractual terms of the instrument), but there is a 40-day period between when notice of conversion is given and when the instrument converts. During this 40-day period, the holder’s election to convert and the issuer’s decision to settle the instrument in cash cannot be changed; those elections are irrevocable once made.

Debt issuance costs are \$30 and are recorded as additional debt discount on the balance sheet.

FG Corp’s stock price is \$20 at the date the convertible debt is issued. FG’s common stock has a par value of \$1 per share. The debt is issued at par.

The convertible debt has the following additional terms:

---

|                   |  |
|-------------------|--|
| Principal amount  | \$1,000  |
| Coupon rate       | 5% paid semi-annually on June 30 and December 31 |
| Years to maturity | 5 years  |
| Conversion price  | \$25   |

---

Two years after FG Corp issues the debt, the investors provide notice of exercise of their conversion options. The next day, FG Corp elects to settle the instruments 100% in cash. However, cash settlement will not occur for a period of 40 trading days and will be based upon an average of the daily volume weighted average price (VWAP) over that period. As noted above, the election to cash-settle the instrument is irrevocable.

FG Corp’s stock price is \$33 at the time of the election to cash settle. The VWAP over the 40-day period is \$35. FG Corp has amortized \$12 of debt issuance costs by the settlement date; therefore, unamortized debt issuance costs are \$18. This example ignores the effects of accrued interest and income taxes for simplicity.

How should FG Corp record the issuance and ultimate conversion of its convertible debt?

*Analysis*

FG Corp would record the following entries.

|                                  |         |         |
|----------------------------------|---------|---------|
| Dr. Cash                         | \$1,000 |         |
| Cr. Debt                         |         | \$1,000 |
| Dr. Deferred debt issuance costs | \$30    |         |
| Cr. Cash                         |         | \$30    |

*To record the issuance of the convertible debt and issuance costs*

Following the irrevocable notice of conversion, when FG Corp makes an irrevocable election to settle the entire instrument in cash, a derivative must be separated from the debt. The conversion option now becomes a forward sale contract which would not be eligible for the “own stock” scope exception as it is required to be settled in cash. The derivative is essentially a forward sale against average VWAP for 40 trading days. In separating a non-option embedded derivative from the host contract under ASC 815-15-25-1, the terms of that non-option embedded derivative should be determined in a manner that results in its fair value generally being equal to zero (see ASC 815-15-55-160 through ASC 815-15-55-164). As a result, there is no accounting entry required on the date FG Corp makes its irrevocable election to settle in cash. For the purposes of this example, we have assumed that there are no differences between the spot and forward prices.

FG Corp’s stock price on the date of irrevocable election to settle in cash was \$33. The average of the daily VWAP over the 40-day period was \$35. As a result, the forward sale contract would become an \$80 liability ( $\$1,000/\$25 \times \$2 = \$80$ ).

FG Corp would record the following entries.

|                          |      |      |
|--------------------------|------|------|
| Dr. Loss                 | \$80 |      |
| Cr. Derivative liability |      | \$80 |

*To record the change in fair value of the derivative during the 40-day settlement period*

|                                  |         |         |
|----------------------------------|---------|---------|
| Dr. Debt                         | \$1,000 |         |
| Dr. Derivative Liability         | \$80    |         |
| Dr. APIC                         | \$338   |         |
| Cr. Deferred debt issuance costs |         | \$18    |
| Cr. Cash                         |         | \$1,400 |

*To derecognize the convertible debt, unamortized debt issuance costs, and derivative liability, and recognize the cash paid upon conversion*

Although the conversion represents the settlement of a bifurcated derivative, we believe that the application of conversion accounting is appropriate, rather than extinguishment accounting because, in this situation, the separation of the derivative is incidental to the settlement of the convertible debt instrument. In other fact patterns, where the conversion option or other bifurcated derivative is other than incidental to settlement, we believe that extinguishment accounting should be applied. See FG 6.5.1 for additional information.

### **EXAMPLE FG 6-6**

**Conversion accounting when convertible debt is issued with a substantial premium and settled entirely in shares**

FG Corp issues convertible debt that will be settled upon conversion entirely in shares. The principal amount of the debt is \$1,000 and proceeds received were \$1,120 in cash. FG Corp concludes that the convertible debt was issued at a substantial premium.

FG Corp's stock price is \$20 at the date the convertible debt is issued. FG's common stock has a par value of \$1 per share. The debt is issued at par.

The convertible debt has the following terms:

|                   |  |
|-------------------|--|
| Principal amount  | \$1,000  |
| Coupon rate       | 5% paid semi-annually on June 30 and December 31 |
| Years to maturity | 5 years  |
| Conversion price  | \$25   |

Two years after FG Corp issues the debt, investors exercise their conversion options. FG Corp's stock price is \$35 at the conversion date.

At issuance, FG Corp concludes that the conversion feature is not required to be bifurcated and there are no other embedded features in the convertible debt.

This example ignores the effects of debt issuance costs, accrued interest and income taxes for simplicity.

How should FG Corp record the issuance and conversion of its convertible debt?

#### *Analysis*

To record the convertible debt with a substantial premium at issuance, FG Corp should record the following entry.

|                                |         |         |
|--------------------------------|---------|---------|
| Dr. Cash                       | \$1,120 |         |
| Cr. Convertible debt           |         | \$1,000 |
| Cr. Additional paid-in capital |         | \$120   |

To derecognize the convertible debt and recognize the common stock issued upon conversion, FG Corp should record the following entry.

|                                |         |       |
|--------------------------------|---------|-------|
| Dr. Convertible debt           | \$1,000 |       |
| Cr. Common stock – par value   |         | \$40  |
| Cr. Additional paid-in capital |         | \$960 |

As discussed in ASC 470-20-40-5(a), the conversion of a debt instrument that becomes convertible upon the reporting entity's exercise of a call option should be accounted for using the contractual conversion accounting model if, at time of issuance, the debt instrument contains a substantive conversion feature and the instrument is converting pursuant to its contractual terms.

### **6.8.1 Conversion of debt with nonsubstantive conversion option—after adoption of ASU 2020-06**

ASC 470-20-40-5(b) provides guidance on the conversion of a debt instrument that becomes convertible upon the reporting entity's exercise of a call option when the conversion option is nonsubstantive.

#### **ASC 470-20-40-5(b)**

No substantive conversion feature. If the debt instrument did not contain a substantive conversion feature as of time of issuance, the issuance of equity securities shall be accounted for as a debt extinguishment. That is, the fair value of the equity securities issued should be considered a component of the reacquisition price of the debt.

To be considered substantive, a conversion option should be at least reasonably possible of being exercised in the future. Many conversion options meet that definition and are substantive. However, a conversion option which (1) is exercisable only upon exercise of the reporting entity's call option at par, or (2) has an extremely high conversion price relative to the price of the underlying shares at inception may not be substantive.

ASC 470-20-40-7 through ASC 470-20-40-9 provide guidance on determining whether a conversion option is substantive.

#### **ASC 470-20-40-7**

By definition, a substantive conversion feature is at least reasonably possible of being exercised in the future. If the conversion price of an instrument at issuance is extremely high so that conversion of the instrument is not deemed at least reasonably possible as of its issuance date, then the conversion feature would not be considered substantive.

**ASC 470-20-40-8**

For purposes of determining whether a conversion feature is reasonably possible of being exercised, the assessment of the holder's intent is not necessary. Therefore, even if such an instrument included a conversion feature that provided for conversion due solely to the passage of time (for example, the instrument will become convertible at a date before its maturity date), it would be inappropriate to conclude that the conversion feature is substantive. Also, an instrument that became convertible only upon the issuer's exercise of its call option does not possess a substantive conversion feature.

**ASC 470-20-40-9**

Methods that may be helpful in assessing whether a conversion feature is substantive include the following:

- a. The fair value of the conversion feature relative to the fair value of the debt instrument. Comparing the fair value of a conversion feature to the fair value of the debt instrument (that is, the complete instrument as issued) may provide evidence that the conversion feature is substantive.
- b. The effective annual interest rate per the terms of the debt instrument relative to the estimated effective annual rate of a nonconvertible debt instrument with an equivalent expected term and credit risk. Comparing the effective annual interest rate of the debt instrument to the effective annual rate the issuer estimates it could obtain on a similar nonconvertible instrument may provide evidence that a conversion feature is substantive.
- c. The fair value of the debt instrument relative to an instrument that is identical except for which the conversion option is not contingent. Comparing the fair value of the debt instrument to the fair value of an identical instrument for which conversion is not contingent isolates the effect of the contingencies and may provide evidence about the substance of a conversion feature. If the fair value of the debt instrument is similar to the fair value of an identical convertible debt instrument for which conversion is not contingent, then it may indicate that the conversion feature is substantive. However, this approach may not be appropriate unless it is clear that the conversion feature, not considering the contingencies, is substantive.
- d. Qualitative evaluation of the conversion provisions. The nature of the conditions under which the instrument may become convertible may provide evidence that the conversion feature is substantive. For example, if an instrument may become convertible upon the occurrence of a specified contingent event, the likelihood that the contingent event will occur before the instrument's maturity date may indicate that the conversion feature is substantive. However, this approach may not be appropriate unless it is clear that the conversion feature, not considering the contingencies, is substantive.

**6.8.2 Induced conversion—after adoption of ASU 2020-06**

An induced conversion is a transaction in which a reporting entity offers additional shares or other consideration (“sweeteners”) to investors to incentivize them to convert their convertible instrument. For example, a reporting entity may reduce the original conversion price or issue additional consideration (e.g., cash or warrants) not provided for in the original conversion terms to debt holders that agree to convert during a limited offer period. ASC 470-20-40-13 and ASC 470-20-40-14 provide guidance on which transactions are induced conversions.

**ASC 470-20-40-13**

The guidance in paragraph 470-20-40-16 applies to conversions of convertible debt to equity securities pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. That guidance applies only to conversions that both:

- a. Occur pursuant to changed conversion privileges that are exercisable only for a limited period of time (inducements offered without a restrictive time limit on their exercisability are not, by their structure, changes made to induce prompt conversion)
- b. Include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted, regardless of the party that initiates the offer or whether the offer relates to all debt holders.

**ASC 470-20-40-14**

A conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt. The preceding paragraph also includes conversions pursuant to amended or altered conversion privileges on such instruments, even though they are literally provided in the terms of the debt at issuance.

If a transaction qualifies as an induced conversion, ASC 470-20-40-16 requires a reporting entity to recognize an expense equal to the fair value of the shares or other consideration issued to induce conversion (i.e., the fair value of all consideration transferred in excess of the fair value of the consideration that would be transferred pursuant to the original conversion terms).

***Induced conversion—convertible debt with a cash conversion feature—after adoption of ASU 2020-06***

Two of the more popular types of convertible debt instruments either require or permit the reporting entity to settle the instrument upon conversion either partially or fully in cash. A convertible debt instrument that upon conversion requires the reporting entity to settle the principal amount in cash and permits the reporting entity to settle the conversion spread in either cash or shares is commonly referred to as “Instrument C.” A convertible debt instrument that allows the reporting entity to settle the instrument in cash or shares in any combination upon conversion is commonly referred to as “Instrument X.” The settlement flexibility provided by these instruments, in particular Instrument X, can make it difficult to determine whether induced conversion accounting or extinguishment accounting should apply.

In order to have an induced conversion, there must first be a conversion of the instrument in accordance with its contractual terms. This does not need to occur as a result of a legal exercise of the conversion option. ASC 470-20-40-4 clarifies that when, “a convertible debt instrument accounted for in its entirety as a liability ... is converted into shares, cash (or other assets), or any combination of shares and cash (or other assets), in accordance with the conversion privileges provided in the terms of the instrument...,” conversion accounting as described in FG 6.8 applies. This means that even when an instrument is settled entirely in cash, conversion accounting applies, provided that the original terms of the instrument allow for full cash settlement. After determining that the settlement of the

instrument includes the issuance of at least the minimum contractually-required consideration specified in the original terms of the convertible instrument, a reporting entity should look to ASC 470-20-40-13 through ASC 470-20-40-14 to determine whether induced conversion accounting applies.

When the settlement of a convertible debt instrument does not include at least the minimum contractually-required consideration present in the original terms of the instrument, we believe that extinguishment accounting should apply. For example, if a convertible debt instrument that requires the principal amount to be settled in cash is settled with the principal amount partially settled in cash and partially settled in shares, extinguishment accounting should apply. In some cases, negotiated settlements of convertible debt instruments may involve changes to formulas that determine the ultimate settlement amount received in a manner other than reducing the conversion price. For example, as illustrated in Example FG 6-5 some convertible instruments with an option for cash settlements calculate settlement amounts based on the VWAP of the underlying shares for a period of time. Changes to how the VWAP is calculated may result in scenarios where holders of the convertible instruments may receive less consideration under the revised conversion terms as compared to the original conversion terms. Such situations should be carefully evaluated to determine if extinguishment accounting should apply.

If a transaction of this nature does not qualify to be considered an induced conversion, an entity is required to apply extinguishment accounting. See FG 3.7.

### Question FG 6-3

What is a “limited period of time” as used in ASC 470-20-40-13?

#### *PwC response*

We believe that when evaluating the effective time period of a change in conversion privileges, the reporting entity’s intent in offering the sweetener should be to induce prompt conversion of the convertible instrument. Generally, 30-60 days would be considered a limited period of time.

### Question FG 6-4

If an investor offers to surrender a convertible instrument that upon conversion contractually requires gross physical settlement through the issuance of shares in exchange for more shares of stock than it is entitled to under the original conversion terms, and the offer is valid for a limited period of time, should the reporting entity account for the transaction as an induced conversion or extinguishment?

#### *PwC response*

The reporting entity should account for the transaction as an induced conversion. The party that makes the offer should not affect the accounting; thus, inducement accounting is not affected by which party makes the offer.



### Question FG 6-5

A reporting entity extends an offer to investors, for a limited period of time, to allow investors to tender their convertible instruments (that contractually require gross physical settlement in shares) in exchange for cash and shares. The total value of consideration that could be received is greater than the value of the shares that the investor is entitled to under the original conversion terms; however, the number of shares the investor will receive is less than the number of shares it is entitled to under the original conversion terms.

Should the reporting entity account for the transaction as an induced conversion or as an extinguishment?

#### ***PwC response***

The reporting entity should account for the transaction as an extinguishment. ASC 470-20-40-13(b) requires all equity securities issuable pursuant to the original conversion privileges to be issued for the conversion to be an induced conversion. If fewer shares are issued, this condition is not met and extinguishment accounting should be applied.

## 6.9 ***Other rights and arrangements—after adoption of ASU 2020-06***

A convertible instrument may have embedded components other than the embedded conversion option. In addition, a reporting entity may execute agreements in connection with the issuance of a convertible instrument. In the following sections we describe some of the more common embedded components and other agreements.

See FG 1.7 for information on registration rights and FG 1.6.1 for information on the evaluation of embedded put and call options in debt host instruments.

### 6.9.1 ***Contingent interest—after adoption of ASU 2020-06***

A contingent interest feature requires additional interest to be paid only when certain conditions exist. Typically, contingent interest features are included for tax purposes to allow the reporting entity to deduct interest expense in excess of the cash coupon paid, although the extra deductions are subject to recapture. In addition, contingent interest can deter investors from exercising their put or conversion option.

A contingent interest provision in convertible debt typically requires the payment of additional interest if the instrument's average trading price is at a specified level above or below par value. For example, a provision may call for contingent interest in the amount of 25 basis points multiplied by the instrument's trading price to be paid if the average trading price is above \$120. Many contingent interest features become effective only after a simultaneous put and call date.

A contingent interest feature that meets the definition of a derivative should be considered clearly and closely related to a debt host when indexed *solely* to interest rates and credit risk. However, the trading price of a convertible debt instrument is a function of more than just interest rates and credit risk due to the embedded conversion option. As a result, contingent interest features in convertible debt instruments that are indexed to the instrument's trading price are generally not considered clearly and closely related to the debt host and should be separated and accounted for as a derivative.

The determination of the likelihood of paying contingent interest should be consistent for book and tax purposes. That is, if when determining the fair value of the bifurcated derivative for book purposes a reporting entity determines the likelihood of payment is remote, then the same assertion should be used when determining if the interest is deductible for tax purposes. See TX 9.4.2 for information on the tax accounting considerations of contingent interest.

### **6.9.2 Greenshoe (overallotment option)—after adoption of ASU 2020-06**

A greenshoe is a freestanding agreement between a reporting entity and an underwriter that allows the underwriter to call additional securities to “upsized” the amount of securities issued. These agreements are a mechanism that in part, enables the underwriter to stabilize prices.

Prior to the issuance of a convertible instrument, an underwriter will take orders from investors. The underwriter will then allocate the base amount plus any greenshoe amount to the investors. The amount allocated to investors in excess of the base amount is called an overallotment. The underwriter can fill an overallotment by exercising the greenshoe.

There are several types of greenshoes, the most common being an overallotment option. An overallotment option allows the underwriter to call additional securities from the reporting entity *only* to fill overallotments. The underwriter cannot exercise an overallotment option and hold or sell the securities for its own account. Other types of greenshoes allow the underwriter full discretion over the securities received by exercising their option.

A greenshoe on a publicly traded instrument generally will meet the definition of a derivative and, for issuances of convertible debt, will not meet the requirements for the scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a). As a result, a greenshoe on publicly traded debt is generally accounted for as a derivative under the guidance in ASC 815. The greenshoe is a written call option by the issuer on the convertible debt. As such, a portion of the proceeds received on the issuance of the convertible debt should be allocated to this written option based on its fair value. As a result, a discount (or a reduction of premium) will be created on the convertible debt. Since the written option meets the definition of a derivative, it should be subsequently measured at fair value, with changes in fair value recorded through earnings. Greenshoes are generally exercisable for a short period of time (typically less than 30 days) with an at the money strike price.

A greenshoe on a privately placed instrument may not meet the definition of a derivative if the instrument is not readily convertible to cash. However, it is still a written call option and reporting entities should consider the SEC’s longstanding view on written options under which the greenshoe would be recorded at fair value, with changes in fair value reported through earnings.

### **6.9.3 Call option overlay—after adoption of ASU 2020-06**

A call option overlay (call spread, capped call) is a transaction executed between a reporting entity issuing a convertible debt instrument and an investment bank. In a call option overlay, the reporting entity buys a call option from the investment bank that mirrors the conversion option embedded in the convertible debt instrument, effectively “hedging” or canceling the economic effect of the embedded conversion option. The reporting entity pays a premium to the investment bank to buy this option. The reporting entity then sells a call option to the investment bank, almost always at a higher strike price than the embedded conversion option and purchased call option, economically raising the strike price of the convertible debt instrument transaction. If the strike price of the sold call option is higher than

the strike price of the purchased call option, the reporting entity will receive a lower premium from the investment bank for selling this option.

The primary reasons a reporting entity may execute a call option overlay transaction are (1) to receive additional tax benefits and (2) to synthetically raise the strike price on the convertible debt instrument.

A call option overlay may be executed as two separate call option transactions—frequently referred to as a call spread—or it can be executed as a single integrated transaction—frequently referred to as a capped call. A call spread and a capped call are accounted for separately from the convertible debt instrument with which they are issued or associated. A call spread is accounted for as two transactions (1) a purchased call option on the reporting entity’s own stock and (2) a written call option on the reporting entity’s own stock at a higher strike price (if each of the instruments meets the definition of a freestanding financial instrument), whereas a capped call is accounted for as a single transaction. See FG 5.6 for information on the analysis of freestanding equity-linked instruments.

A call option overlay is included in diluted EPS based on the form of the transaction and the determination as to whether each of the instruments meets the definition of a freestanding financial instrument. A capped call generally is not included in diluted EPS because it is anti-dilutive. In a call spread, however, the purchased call is not included in diluted EPS because it is anti-dilutive, but the sold call is included in diluted EPS when dilutive. This can create so called “double dilution” from the convertible debt instrument and the sold call, if the reporting entity’s stock price increases to a level above the strike price on the sold call.

#### **6.9.4 Share-lending arrangements—after adoption of ASU 2020-06**

Less commonly, a reporting entity issuing a convertible debt instrument may enter into a share-lending agreement with an investment bank. A share-lending agreement is intended to facilitate the ability of investors, primarily hedge funds, to borrow shares to hedge the conversion option in the convertible debt instrument. Typically, they are executed in situations where the issuing reporting entity’s stock is difficult or expensive to borrow in the conventional stock borrow market.

The terms of a share-lending arrangement typically require the reporting entity to issue (loan) shares to the investment bank in exchange for a small fee, generally equal to the par value of the common stock. Upon conversion or maturity of the convertible debt, the investment bank is required to return the loaned shares to the reporting entity. The shares issued are legally outstanding, entitled to vote, and entitled to dividends, although under the terms of the arrangement the investment bank may agree to reimburse the issuer for dividends received and may agree not to vote on any matters submitted to a vote of the reporting entity’s shareholders.

ASC 470-20-25-20A and ASC 470-20-35-11A provide guidance on the accounting for a share-lending arrangement.

#### **ASC 470-20-25-20A**

At the date of issuance, a share-lending arrangement entered into on an entity’s own shares in contemplation of a convertible debt offering or other financing shall be measured at fair value (in accordance with Topic 820) and recognized as an issuance cost, with an offset to additional paid-in capital in the financial statements of the entity.

**ASC 470-20-35-11A**

If it becomes probable that the counterparty to a share-lending arrangement will default, the issuer of the share-lending arrangement shall recognize an expense equal to the then fair value of the unreturned shares, net of the fair value of probable recoveries, with an offset to additional paid-in capital. The issuer of the share-lending arrangement shall remeasure the fair value of the unreturned shares each reporting period through earnings until the arrangement consideration payable by the counterparty becomes fixed. Subsequent changes in the amount of the probable recoveries should also be recognized in earnings.

Amortization of the discount created by the fair value of the share lending agreement which is treated as a debt issuance cost will increase the overall implied cost of the convertible debt. See FG 1.2.3 for information on the amortization of debt issuance costs.

See FSP 7.4.3.7 for information on the earnings per share treatment of share lending arrangements.

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***Chapter 6A:  
Convertible debt—before  
adoption of ASU 2020-06  
—updated October 2020***

## 6.1A Chapter overview of convertible debt accounting—before adoption of ASU 2020-06

This chapter discusses the accounting for convertible debt, including the accounting treatment of modifications, conversion, and extinguishment of convertible debt.

Determining the appropriate accounting for convertible debt requires a detailed understanding of the instrument's terms. It will typically require an evaluation of potential embedded derivatives and cash conversion features. The accounting literature that applies to convertible instruments can be difficult to navigate and apply.

### *New guidance*

In August 2020, the FASB issued 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)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the “own stock” scope exception (see FG 5) and certain aspects of the EPS guidance.

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

The guidance in this chapter reflects the guidance before a reporting entity has adopted ASU 2020-06. See FG 6 for convertible debt accounting guidance after the adoption of ASU 2020-06.

## 6.2A Convertible instruments overview—before adoption of ASU 2020-06

Convertible instruments are debt or equity instruments that either require or permit the investor to convert the instrument into equity securities of the issuer. Some convertible instruments are convertible only upon the occurrence of a specified contingent event (e.g., upon an IPO).

An optionally convertible instrument is a debt or equity instrument that the investor has the option to (1) hold to maturity and redeem for par value, or (2) exercise the conversion option and receive shares. Convertible instruments are usually settled in the issuer's common shares. If the conversion option is “in the money,” the shares are worth more than the par value of the instrument. Investors typically exercise the conversion option when it is in the money at (or close to) the instrument's maturity date. Exercising the conversion option at an earlier date causes the investor to forfeit the remaining time

value of the conversion option. Rather than early exercising a conversion option, investors looking to exit a convertible instrument often sell it to another investor that will pay for both the intrinsic and time value of the conversion option. If the issuer's common stock price does not reach a level where the conversion option is in the money, the investor may decide not to exercise its option, the instrument will mature, and the investor will receive the par or stated value.

One of the key benefits to convertible instrument issuers is the relatively low cash coupon or dividend when compared to a similar nonconvertible instrument. The reduced interest or dividend rate is a result of the value of the conversion option. In other words, the issuer of a convertible instrument "buys down" the interest rate or dividend by selling the investor the conversion option embedded in the debt or equity host instrument.

See FG 7 for information on the accounting for convertible preferred stock.

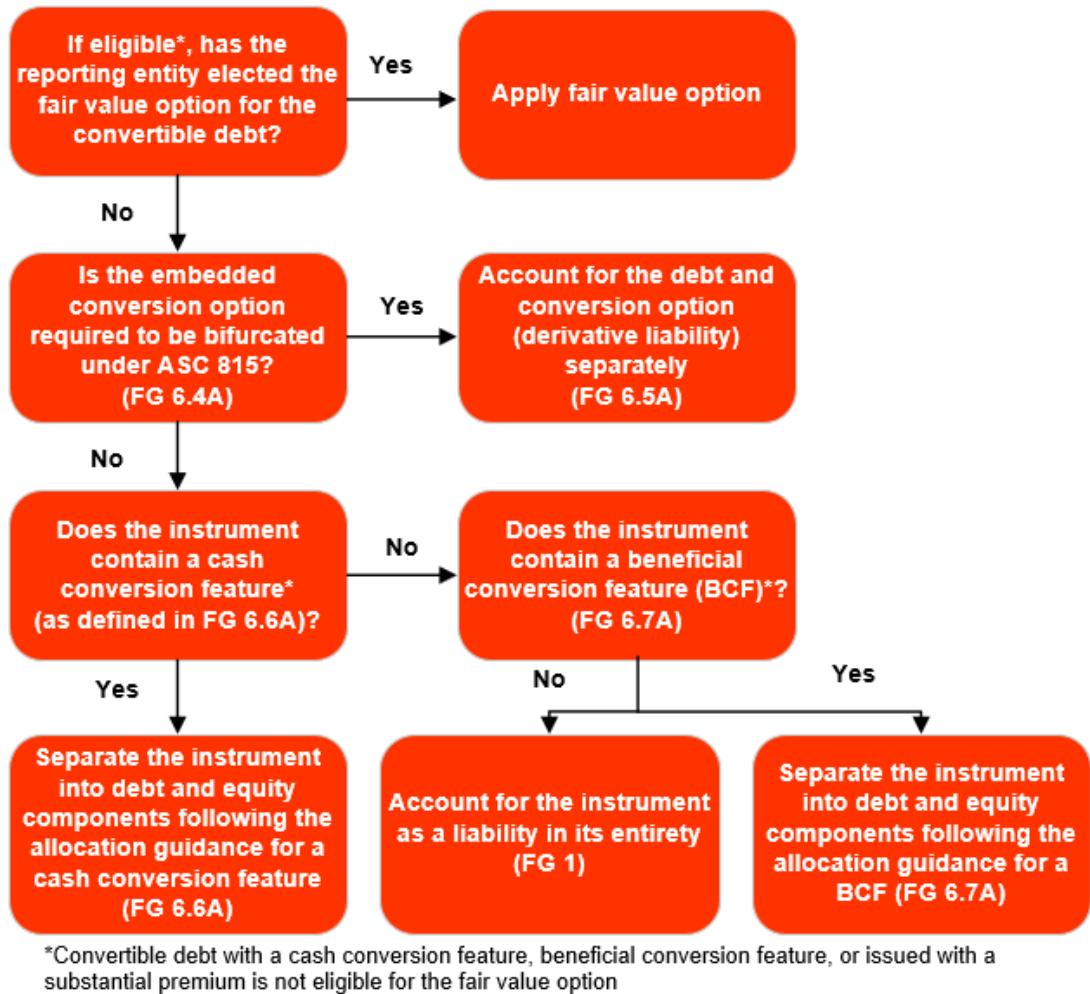
### **6.3A *Analysis of convertible debt—before adoption of ASU 2020-06***

The accounting treatment for a convertible debt instrument depends on the terms of the instrument, including the manner in which the instrument is settled upon conversion. Some convertible debt instruments are settled upon conversion entirely in shares, some in a combination of cash and shares, and, less commonly, entirely in cash. The terms of the convertible debt instrument may mandate a settlement method, or the reporting entity may have a choice.

In addition, many convertible debt instruments contain a number of provisions—such as put and call options or contingent interest features—that should be assessed to determine whether the features should be accounted for separately.

Figure FG 6-1A provides a framework for determining the appropriate accounting for the issuance of convertible debt.

**Figure FG 6-1A**  
Analysis of convertible debt



This framework will help a reporting entity determine which of the four accounting models it should follow when accounting for its convertible debt. Each is summarized in Figure FG 6-2A.



**Figure FG 6-2A**

## Methods for accounting for convertible debt

| <b>Method</b>  | <b>Description of methodology</b>  |
|--|--|
| <b>Single instrument</b><br>(FG 1)                                 | <ul style="list-style-type: none"> <li>□ Record a liability equal to the proceeds received from issuance</li> <li>□ Amortize any discount or premium in the same manner as nonconvertible debt (see FG 1.2.3)</li> <li>□ Account for an extinguishment of the instrument as discussed in FG 3.7</li> <li>□ Account for a conversion of the instrument as discussed in FG 6.9A</li> </ul>   |
| <b>Derivative separation</b><br>(FG 6.5A)                          | <ul style="list-style-type: none"> <li>□ Determine the fair value of the embedded conversion option</li> <li>□ Record the conversion option at fair value and reduce the convertible debt liability by an equivalent amount</li> <li>□ Carry the conversion option as a liability at fair value with changes in fair value recorded in the income statement</li> <li>□ Amortize any discount or premium in the same manner as nonconvertible debt (see FG 1.2.3)</li> <li>□ Account for derecognition as discussed in FG 6.5.1A</li> </ul>   |
| <b>Cash conversion option separation</b><br>(FG 6.6A)              | <ul style="list-style-type: none"> <li>□ Determine the fair value of the debt liability by determining the fair value of an equivalent debt instrument without a conversion option</li> <li>□ The difference between the proceeds received and the debt liability is recorded in additional paid-in capital</li> <li>□ No subsequent remeasurement of the amount recorded in equity</li> <li>□ Amortize the discount on the debt liability to interest expense over the expected life of the debt instrument</li> <li>□ Account for derecognition as discussed in FG 6.6.5A</li> </ul> |
| <b>Beneficial conversion feature (BCF) separation</b><br>(FG 6.7A) | <ul style="list-style-type: none"> <li>□ Determine the BCF amount based on the in-the-money amount of the conversion option</li> <li>□ Record the BCF in additional paid-in capital and record a corresponding discount on the debt liability</li> <li>□ No subsequent remeasurement of the amount recorded in equity</li> <li>□ Amortize any discount or premium in the same manner as nonconvertible debt (see FG 1.2.3)</li> <li>□ Account for derecognition as discussed in FG 6.7.5A</li> </ul>   |

Convertible debt instruments that are separated into a debt and an equity component based on the guidance in ASC 470-20, *Debt with Conversion and Other Options*, such as debt with a cash conversion feature, beneficial conversion feature, or substantial premium, are not eligible for the fair value option under ASC 825, *Financial Instruments*, based on the guidance in ASC 825-10-15-5(f). ASC 825-10-15-5(f) precludes application of the fair value option to financial instruments that are classified in whole or in part in equity. All other convertible debt instruments may be carried at fair value by the issuer, although this is typically not the case.

## **6.4A Analysis of the embedded conversion option—before adoption of ASU 2020-06**

ASC 815, *Derivatives and Hedging*, provides guidance on when an embedded component should be separated from its host instrument and accounted for separately as a derivative.

### **ASC 815-15-25-1**

An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

This guidance applies to conversion options (and other embedded components such as call and put options or contingent interest) embedded in convertible debt instruments. Many convertible debt instruments contain a conversion option with multiple exercise triggers or contingent events that must occur for a conversion option to become operable. Each exercise trigger may also lead to certain settlement adjustments. These convertible debt instruments are often referred to as “CoCos,” which is shorthand for contingently convertible debt. Some of the more common exercise triggers include (1) a sales price condition, (2) a trading price condition, (3) a notice of redemption, and (4) certain corporate events (e.g., a change of control). Typically, if after performing the analysis of one exercise trigger, it is determined that it should be separately accounted for as a derivative, then the entire conversion option should be separated and accounted for as a single derivative.

### **6.4.1A Clearly and closely related conversion options—before adoption of ASU 2020-06**

When considering whether an embedded equity-linked component is clearly and closely related to its host instrument, a reporting entity should first determine whether the host is an equity host or a debt host. Instruments classified as debt, such as convertible debt instruments, are considered debt hosts. An embedded equity-linked component is generally not considered clearly and closely related to a debt host.

**6.4.2A Conversion option—derivative definition—before adoption of ASU 2020-06**

To determine whether a conversion option meets the definition of a derivative, its terms should be evaluated under the guidance in ASC 815-10-15-83. Typically, the criterion that ultimately determines whether or not a conversion option meets the definition of a derivative is the net settlement criterion. If the equity securities underlying the embedded conversion option are readily convertible to cash, such as publicly traded common shares, the embedded conversion option is likely to meet the net settlement criterion to be considered a derivative. If the equity securities underlying the conversion option are not readily convertible to cash, and the conversion option requires gross physical settlement of the underlying shares, the embedded conversion option may not meet the net settlement criterion, and therefore would not meet the definition of a derivative. If the conversion option permits settlement by delivery of net shares (a variable number of shares with a value equal to the intrinsic value of the conversion option) or cash, then it meets the definition of a derivative. See FG 5.4.2 and DH 2.3.5.3 for further information on the concept of readily convertible to cash and DH 2.3.5 for further information on other forms of net settlement.

If an embedded conversion option meets the definition of a derivative, a reporting entity should assess whether it qualifies for the scope exception for certain contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

**6.4.2.1A Conversion option—issuer own equity scope exception—before adoption of ASU 2020-06**

ASC 815-10-15-74(a) provides a scope exception to the derivative accounting required under ASC 815, for certain contracts involving a reporting entity's own equity.

**ASC 815-10-15-74(a)**

Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- a. Contracts issued or held by that reporting entity that are both:
  1. Indexed to its own stock
  2. Classified in stockholders' equity in its statement of financial position.

An embedded component is considered indexed to a reporting entity's own stock if it meets the requirements specified in ASC 815-40-15. See FG 5.6.2A for information on those requirements.

***Application to convertible debt***

To apply the requirements for equity classification to a conversion option embedded in a convertible debt instrument, the issuer should first determine whether the convertible debt instrument is considered "conventional." ASC 815-40-25-39 describes a conventional convertible debt instrument as one "in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer)."

If convertible debt is considered conventional, the reporting entity only needs to consider the stated settlement alternatives (i.e., who controls the settlement and whether the settlement will be in shares or cash) to determine whether the embedded conversion option meets the requirements for equity classification. The additional requirements for equity classification in ASC 815-40-25-10 and ASC 815-40-55-2 through ASC 815-40-55-6 are not applicable. If the convertible debt instrument is not conventional, the reporting entity should consider all of the requirements for equity classification in ASC 815. See FG 5.6.2A and FG 5.6.3A for information on those requirements.

ASC 815-40-25-39 through ASC 815-40-25-41 explain the application of the criteria in ASC 815-40-25-10 to conventional convertible debt.

Question FG 6-1A discusses whether a convertible debt instrument that contains a “make-whole” provision is considered a conventional convertible debt instrument.

### Question FG 6-1A

Is a convertible debt instrument that provides for an adjustment to the number of shares deliverable upon conversion via a “make-whole” provision or table (i.e., a provision designed to compensate investors for unanticipated changes to the issuer), as is market standard practice, considered a conventional convertible debt instrument?

#### ***PwC response***

No. Generally, an adjustment to the conversion option for anything other than standard anti-dilution provisions (e.g., adjustments for stock splits, rights offerings, dividends, or spin-offs) precludes a convertible debt instrument from being considered conventional. The fact that such a provision is standard practice is not relevant in determining whether an instrument is conventional as defined in ASC 815-40-25-39.

#### ***Application to a contingent conversion option***

A contingent conversion option includes a contingency that determines whether the investor has the right to convert into equity (e.g., convertible only in the event of a successful IPO). To determine whether this type of conversion option should be accounted for separately as a derivative, a reporting entity should consider whether it qualifies for the scope exception for contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a).

If a conversion option contingency is tied to an event (e.g., an IPO), the contingency may not affect whether the embedded component is considered indexed to the issuer’s stock. If a conversion option contingency is tied to an observable index, the contingency precludes the embedded component from being considered indexed to the issuer’s stock, unless the contingency is based on (1) the issuer’s stock price, or (2) a measure referencing the issuer’s operations (e.g., EBITDA). The reporting entity must also evaluate all of the instrument’s settlement provisions and evaluate the conditions necessary for equity classification.

If an instrument’s conversion is tied to achieving a substantive contingency based on an event or index other than the issuer’s stock price, the instrument should not be included in diluted earnings per share until the contingency has been met. See FSP 7.5.6.4 for information on earnings per share for contingently exercisable instruments and FSP 12.7A for balance sheet classification considerations applicable to contingently convertible debt.

***Application to an adjustment to a conversion option upon a fundamental change***

Many convertible debt instruments provide for an adjustment to the number of shares deliverable if a fundamental change triggers an early conversion. To determine whether this type of conversion option should be accounted for separately as a derivative, a reporting entity should consider whether it qualifies for the scope exception for contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

In accordance with ASC 815-40-15-7D, if the number of shares used to calculate an instrument's settlement amount is not fixed, it could still be considered indexed to a reporting entity's own stock if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on equity shares (e.g., strike price, term, stock price volatility).

This provision is typically included primarily to compensate the investor for the time value of the option lost upon an unanticipated change, such as a change in control. Typically, the adjustment to the number of shares is included in a matrix of the issuer's stock price and time to maturity. The number of shares to be received upon conversion decreases as the stock price increases and time to maturity decreases. However, because option time value is not linear, neither is the adjustment.

The example in ASC 815-40-55-45 and ASC 815-40-55-46 (excerpted in the following section) concludes that a provision that uses a "make-whole" table to calculate the adjustment to the number of shares delivered upon conversion in the event of a fundamental change should be considered indexed to the reporting entity's own stock because the number of shares delivered is determined based upon the issuer's stock price and time to maturity, both of which are inputs to a fair value measurement of a fixed-for-fixed option on equity shares.

In addition, make-whole tables typically include a cap on the number of shares the reporting entity could be required to deliver upon conversion, which addresses one of the requirements for equity classification in ASC 815-40-25. Provided the other requirements for equity classification in ASC 815-40 are met, a conversion option which provides an adjustment (based on the issuer's stock price and time to maturity) to the number of shares delivered upon conversion in the event of a fundamental change would meet the requirements for the scope exception for contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

Convertible debt instruments often contain put options that allow investors to put the debt to the issuer (for par or some other stated amount) upon a fundamental change. Depending on the terms, such a put option may comprise both a traditional put right and a contingently exercisable conversion right, as discussed in Question FG 6-2A. See FG 1.6.1 for information on evaluating put and call options embedded in debt instruments.

## Question FG 6-2A

Should an option that, in the event of a fundamental change, allows an investor to put a convertible debt instrument to the reporting entity for cash equal to the greater of (1) the par value of the debt instrument or (2) the converted value of the debt instrument be separated from the convertible debt instrument?

### *PwC response*

The put option upon a fundamental change is really two options (1) a put option at par value and (2) a contingently exercisable conversion option, which must be settled in cash.

The put option at par value needs to be evaluated to determine whether it should be separated (see FG 1.6.1).

The entire embedded conversion option should be separated. A conversion option that must be settled in cash in circumstances beyond the reporting entity's control is not eligible for the scope exception for certain contracts involving a reporting entity's own equity in ASC 815-10-15-74(a). Although the cash settlement provision is only included in the conversion option exercisable upon a fundamental change, if one settlement alternative fails to qualify for the scope exception, the entire conversion option should be separated and carried at fair value with changes in fair value recorded in the income statement.

### *Application to a conversion option with a trading price condition (parity provision)*

Many convertible debt instruments with a contingent conversion option contain a provision that permits the investor to exercise the conversion option if the debt instrument is trading below a specified percentage, for example 98% of the parity value of the underlying shares (referred to as a "parity provision"). This provision is typically included to provide protection to the investor by allowing conversion in a scenario when they may want to convert, but would be unable to do so because other triggers for the contingent conversion have yet to be met. Theoretically, a convertible debt instrument should be worth more than the underlying shares because a convertible debt instrument provides a floor on the value to be received (absent an event involving the credit of the reporting entity, the investor will receive at least the par value of the debt instrument at maturity) as well as coupon payments over the life of the debt instrument. A parity provision is likely to only be triggered in periods of extreme market disruption that impact the value of the convertible debt instrument and shares.

To determine whether a conversion option with a parity provision should be separated and accounted for as a derivative, a reporting entity should consider whether it qualifies for the scope exception for contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

ASC 815-40-55-45 through ASC 815-40-55-46 analyze the application of the scope exception to an instrument with a market (trading) price trigger, a parity provision, and a merger provision.

**>> Example 19: Variability involving contingently convertible debt with a market price trigger, parity provision, and merger provision**

**ASC 815-40-55-45**

This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A issues a contingently convertible debt instrument with a par value of \$1,000 that is convertible into 100 shares of its common stock. The convertible debt instrument has a 10-year term and is convertible at any time after any of the following events occurs:

- a. Entity A's stock price exceeds \$13 per share (market price trigger).
- b. The convertible debt instrument trades for an amount that is less than 98 percent of its if-converted value (parity provision).
- c. There is an announcement of a merger involving Entity A.

**ASC 815-40-55-46**

The terms of the convertible debt instrument also include a make-whole provision. Under that provision, if Entity A is acquired for cash before a specified date, the holder of the convertible debt instrument can convert into a number of shares equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined by reference to a table with axes of stock price and time. That table was designed such that the aggregate fair value of the shares deliverable (that is, the fair value of 100 shares per bond plus the make-whole shares) would be expected to approximate the fair value of the convertible debt instrument at the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the instrument's inception. The embedded conversion option is considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The market price trigger and parity provision exercise contingencies are based on observable markets; however, those contingencies relate solely to the market prices of the entity's own stock and its own convertible debt. Also, the merger announcement exercise contingency is not an observable market or an index. Therefore, Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.
- b. Step 2. An acquisition for cash before the specified date is the only circumstance in which the settlement amount will not equal the difference between the fair value of 100 shares and a fixed strike price (\$1,000 fixed par value of the debt). The settlement amount if Entity A is acquired for cash before the specified date is equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a fixed-for-fixed option on equity shares.

As described above, if the requirements for equity classification in ASC 815-40-25 are met, a parity provision typically meets the requirements for the scope exception for contracts involving a reporting entity's own equity in ASC 815-10-15-74(a).

***Application to debt convertible into stock of a consolidated subsidiary***

In the consolidated financial statements, debt that is convertible into the stock of a substantive consolidated subsidiary (whether the convertible debt is issued by the parent or the subsidiary) should be accounted for in the same manner as debt that is convertible into the parent company's stock. The

same is not true for instruments indexed to the stock of an affiliate that is not a consolidated subsidiary or to the stock of an equity-method investee. The stock of an affiliate or equity-method investee is not considered the reporting entity's own stock.

Although not specifically addressed, we believe that the guidance in ASC 815-40 also applies to convertible debt issued by a subsidiary that is convertible into the stock of the parent in the consolidated financial statements of the parent. However, in the separate financial statements of the subsidiary, debt convertible into the parent's stock would generally not be considered indexed to the entity's own stock.

See FG 5.6.2.4A for information on instruments indexed to the stock of a subsidiary or affiliate.

### ***Application to instruments convertible into a variable number of shares***

A debt instrument that can be settled by delivery of a variable number of shares should be evaluated to determine whether the embedded conversion option is in substance, a put option (redemption feature) designed to provide the investor with a fixed monetary amount, settleable in shares. For example, a reporting entity may issue a debt instrument that converts, either automatically or at the issuer's option, into a variable number of shares upon the completion of a capital raising transaction. The number of shares received is determined by dividing the instrument's outstanding principal and accrued interest balance by the fair value of the shares. This feature is in substance a put option, which should be evaluated under the guidance in ASC 815 to determine whether the put option should be separated and accounted for as a derivative. Oftentimes, the formula used to calculate the number of shares to be delivered will result in settlement of the convertible debt instrument at a premium. See FG 1.6.1 for information on evaluating put and call options embedded in debt instruments.

### ***Application to down round features***

As discussed in ASC 815-10-15-75A (subsequent to the adoption of ASU 2017-11), a conversion option embedded in a convertible debt instrument that includes a feature that meets the definition of a down round feature in the ASC Master Glossary does not preclude that conversion option from being considered indexed to the entity's own stock.

See FG 5.6.2.2A for further information on antidilution and price protection provisions (including down round features).

## ***6.5A Convertible debt with a separated conversion option—before adoption of ASU 2020-06***

When a reporting entity concludes that a conversion option should be separated from its host debt instrument and accounted for as a derivative, it should be accounted for as a freestanding derivative instrument under the guidance in ASC 815. That is, classified on the balance sheet as a derivative liability at fair value with any changes in its fair value recognized currently in the income statement. The host contract should be accounted for using the guidance applicable to nonconvertible debt.

ASC 815-15-30-2 through ASC 815-15-30-6 provide guidance on allocating the carrying amount of a hybrid instrument between the host contract and the derivative. That guidance requires the derivative to be initially measured at fair value, with the host contract carried at a value equal to the difference between the previous carrying amount of the hybrid instrument and the fair value of the derivative.



Therefore, there is no gain or loss from the initial recognition and measurement of an embedded derivative that is accounted for separately from its host contract. When the embedded derivative is an option, ASC 815-15-30-6 requires it to be separated and recorded at its fair value based on its stated contract terms. The allocation of proceeds to the separated derivative will typically create a discount or premium on the associated host debt instrument.

The embedded derivative should be reassessed each reporting period to determine whether the embedded component subsequently meets the own stock scope exception. See FG 6.5.2A for information on the reclassification of previously separated conversion options.

#### **6.5.1A *Derecognition of debt with separated conversion option—before adoption of ASU 2020-06***

When a conversion feature has been separated from a convertible debt instrument and accounted for as a derivative liability, there is no equity conversion feature remaining in the debt for accounting purposes. Therefore, while there may be a legal conversion of the debt, for accounting purposes we believe that both liabilities (i.e., the debt host and the separated derivative liability) should be subject to extinguishment accounting, because they are being surrendered in exchange for common shares. As such, a gain or loss upon extinguishment of the two liabilities equal to the difference between the recorded value of the liabilities and the fair value of the consideration issued to extinguish them should be recorded.

To account for the conversion of a convertible instrument when the conversion option has been separated and accounted for as a derivative liability, a reporting entity should perform the following steps:

- Update the valuation of the separated conversion option to the date the instrument is legally converted
- Adjust the carrying amount of the host debt instrument to reflect amortization of any premium or discount associated with the host debt instrument up to the date the instrument is legally converted
- Amortize debt issuance costs to the date the instrument is legally converted
- Ensure that the carrying amount of the host debt instrument reflects all components of book value, including the unamortized portion of any premiums or discounts on the debt host recorded as an adjustment to the debt host and any unamortized debt issuance costs, and accrued interest. These items collectively represent the net carrying amount of the debt host used to measure the extinguishment gain or loss
- Calculate the difference between the reacquisition price and the net carrying amount of the debt by comparing the fair value of the consideration (i.e., cash and shares) issued upon conversion to the sum of the updated net carrying amounts of the (1) separated conversion option liability and (2) debt host. Record any difference as an extinguishment gain or loss in the income statement

When updating the valuation of the separated conversion option to the date the instrument is legally converted, reporting entities may adjust the separated conversion option to either its intrinsic value or fair value as of the conversion date. Adjusting the separated conversion option to its intrinsic value reflects the investor's decision to truncate the term of the option by exercising it early. The foregone

time value is recorded as part of the change in fair value of the derivative liability recorded in the income statement, but not as part of the extinguishment transaction. Adjusting the separated conversion option to its fair value allocates the time value foregone by the investor to the gain or loss on extinguishment, rather than the change in the fair value of the derivative liability. Under either approach, the total income statement impact is the same.

Example FG 6-1A illustrates how to account for the derecognition of a convertible debt instrument with a separated conversion option.

### EXAMPLE FG 6-1A

#### Derecognition of convertible debt with a separated conversion option

FG Corp issues convertible debt that is required to be settled upon conversion entirely in cash. FG Corp concludes that the embedded conversion option should be separated from the debt and accounted for as a derivative liability under the guidance in ASC 815. The host debt instrument is accounted for as a liability.

FG Corp determines the fair value of the embedded conversion option to be \$200.

FG Corp's stock price is \$85 at the date the convertible debt is issued. The debt is issued at par and for this example, there are no debt issuance costs.

The convertible debt has the following terms:

|   |  |
|---|--|
| Principal amount                              | \$1,000  |
| Coupon rate                                   | 5% paid semi-annually on June 30 and December 31 |
| Years to maturity                             | 5 years  |
| Conversion price                              | \$100  |
| Number of shares underlying conversion option | 10   |

One year after FG Corp issues the convertible debt, investors exercise their conversion options when the stock price is \$110. FG Corp delivers \$1,100 in cash (\$110 current stock price multiplied by 10 shares underlying the conversion option) to investors.

The fair value of the embedded conversion option is \$380 at the conversion date, one year after issuance and prior to exercise.

This example ignores the effects of accrued interest and income taxes for simplicity.

How should FG Corp record (1) issuance of the convertible debt and (2) conversion of the convertible debt?

*Analysis*

To recognize the conversion option (at fair value of \$200) and the debt host contract (remaining proceeds) upon issuance of the convertible debt, FG Corp should record the following journal entry.

|   |         |       |
|---|---------|-------|
| Dr. Cash  | \$1,000 |       |
| Cr. Debt host instrument                                  |         | \$800 |
| Cr. Derivative liability<br>(separated conversion option) |         | \$200 |

At the end of the first year, FG Corp should (1) update the valuation of the separated conversion option to its fair value of \$380 and (2) amortize the debt discount by recording the following journal entry.

|   |       |       |
|---|-------|-------|
| Dr. Loss on derivative liability                          | \$180 |       |
| Dr. Interest expense<br>(amortization of discount)        | \$32  |       |
| Cr. Debt host instrument                                  |       | \$32  |
| Cr. Derivative liability<br>(separated conversion option) |       | \$180 |

To derecognize the host debt instrument and separated conversion option upon conversion, FG Corp should record the following entries.

First, FG Corp should adjust the value of the separated conversion option. Management elects to adjust the value to its intrinsic value of \$100 at the conversion date (stock price of \$110 less the conversion price of \$100 multiplied by 10 shares). As noted above, adjusting the separated conversion option to its fair value would also have been acceptable.

|   |       |       |
|---|-------|-------|
| Dr. Derivative liability<br>(separated conversion option) | \$280 |       |
| Cr. Gain on derivative liability                          |       | \$280 |

Next, FG Corp should extinguish the debt host instrument and derivative liability and recognize a loss on extinguishment.

|   |       |         |
|---|-------|---------|
| Dr. Debt host instrument                                  | \$832 |         |
| Dr. Derivative liability<br>(separated conversion option) | \$100 |         |
| Dr. Loss on debt extinguishment                           | \$168 |         |
| Cr. Cash  |       | \$1,100 |

---

**6.5.2A** *Reclassification of separated conversion option—before adoption of ASU 2020-06*

ASC 815-15-35-4 provides guidance that addresses a reporting entity's accounting for a previously separated conversion option that no longer meets the criteria for separate accounting.

**ASC 815-15-35-4**

If an embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in this Subtopic, an issuer shall account for the previously bifurcated conversion option by reclassifying the carrying amount of the liability for the conversion option (that is, its fair value on the date of reclassification) to shareholders' equity. Any debt discount recognized when the conversion option was bifurcated from the convertible debt instrument shall continue to be amortized.

ASC 815-15-40-1 and ASC 815-15-40-4 address a reporting entity's accounting upon conversion or extinguishment of an instrument which has previously been separated.

**ASC 815-15-40-1**

If a holder exercises a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to paragraph 815-15-35-4, the issuer shall recognize any unamortized discount remaining at the date of conversion immediately as interest expense.

**ASC 815-15-40-4**

If a convertible debt instrument with a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to the guidance in paragraph 815-15-35-4 is extinguished for cash (or other assets) before its stated maturity date, the entity shall do both of the following:

- a. The portion of the reacquisition price equal to the fair value of the conversion option at the date of the extinguishment shall be allocated to equity.
- b. The remaining reacquisition price shall be allocated to the extinguishment of the debt to determine the amount of gain or loss.

ASC 815-15-50-3 requires a reporting entity to disclose (1) a description of the principal changes causing the embedded conversion option to no longer require separate accounting and (2) the amount of the liability for the conversion option reclassified to stockholder's equity.

## **6.6A *Convertible debt with a cash conversion feature—before adoption of ASU 2020-06***

In traditional, share-settled convertible debt, no cash is received upon conversion. If the investor exercises its conversion option, the full number of shares underlying the debt instrument is received. In contrast, a convertible debt instrument with a cash conversion feature allows, or requires, the reporting entity to settle its obligation upon conversion, in whole or in part, in a combination of cash or stock at the investor or issuers' option or mandatorily. ASC 470-20 provides specific accounting guidance for convertible debt instruments with a cash conversion feature provided the conversion option is not separated under the guidance in ASC 815-15-25-1. See FG 6.4A for information on when a conversion option should be separated from its host debt instrument.

If convertible debt with a cash conversion feature contains an embedded derivative other than the embedded conversion option (e.g., a change in control put option), that embedded derivative should

be evaluated under the guidance in ASC 815 to determine whether it should be accounted for separately before the guidance in ASC 470-20 is applied. Therefore, when evaluating whether an embedded put or call option should be accounted for separate from the host debt instrument, the discount created by separating the conversion option under the guidance in ASC 470-20 should *not* be considered. See FG 1.6.1 for information on embedded put and call options in debt instruments and FG 6.10.1A for information on contingent interest features.

Question FG 6-3A discusses if a reporting entity should apply the cash conversion guidance in ASC 470-20 to convertible debt instrument that permits the reporting entity to settle a portion of its debt in cash upon conversion, if it does not intend to use the cash conversion alternative.

### Question FG 6-3A

Should a reporting entity apply the cash conversion guidance in ASC 470-20 to a convertible debt instrument that permits the reporting entity to settle a portion of its debt in cash upon conversion if it does not intend to use the cash conversion alternative?

#### ***PwC response***

Yes. We believe that the scoping language of the cash conversion subsection of ASC 470-20 is intentionally broad. Any instrument with the possibility of partial cash settlement (or settlement in other assets), even for a small portion of the total conversion value, and regardless of intent to cash settle, should be accounted for using this guidance.

ASC 470-20-15-5 provides exceptions to the scope of the cash conversion guidance.

#### **ASC 470-20-15-5**

The Cash Conversion Subsections do not apply to any of the following instruments:

- a. A convertible preferred share that is classified in equity or temporary equity.
- b. A convertible debt instrument that requires or permits settlement in cash (or other assets) upon conversion only in specific circumstances in which the holders of the underlying shares also would receive the same form of consideration in exchange for their shares.
- c. A convertible debt instrument that requires an issuer's obligation to provide consideration for a fractional share upon conversion to be settled in cash but that does not otherwise require or permit settlement in cash (or other assets) upon conversion.

Although ASC 470-20-15-5 exempts equity-classified convertible preferred shares from the cash conversion guidance in ASC 470-20, the guidance does apply to convertible preferred shares that are classified as liabilities for financial reporting purposes.

### **6.6.1A Initial measurement and recognition—before adoption of ASU 2020-06**

Convertible debt with a cash conversion feature should be separated into a debt component and an equity component. This is done by:

- Determining the carrying amount of the debt component based on the fair value of a similar debt instrument *excluding* the embedded conversion option. Typically, an income valuation approach,

- or a present value calculation, is used to calculate the fair value of the debt liability. To perform this calculation, the issuer should determine (1) the expected life of the debt (see FG 6.6.1.1A for further information), and (2) the borrowing rate of a nonconvertible debt instrument (see FG 6.6.1.2A for further information)
- Recognizing the equity component by ascribing the difference between the proceeds and the fair value of the debt liability to additional paid-in capital
  - Reporting the difference between the principal amount of the debt and the amount of the proceeds allocated to the debt component as a debt discount, which is subsequently amortized through interest expense over the instrument's expected life using the interest method

Convertible debt instruments that are separated into a debt and equity component in accordance with the guidance in ASC 470-20 are not eligible for the fair value option under ASC 825, based on the guidance in ASC 825-10-15-5(f). ASC 825-10-15-5(f) precludes application of the fair value option to financial instruments that are, in whole or in part, classified in equity by a reporting entity.

Issuance costs should be allocated to the debt and equity components in proportion to the allocation of proceeds to those components. Allocated costs should be accounted for as debt issuance costs (capitalized and amortized to interest expense using the interest method) and equity issuance costs (charged to equity), respectively.

#### **6.6.1.1A Determining the expected life—before adoption of ASU 2020-06**

To calculate the fair value of convertible debt exclusive of its embedded conversion option, an issuer should estimate the instrument's expected life. When determining the expected life, all substantive embedded features, other than the embedded conversion option, should be considered.

ASC 470-20-30-30 provides guidance on whether an embedded feature is nonsubstantive.

#### **ASC 470-20-30-30**

Solely for purposes of applying the initial measurement guidance in paragraphs 470-20-30-27 through 30-28 and the subsequent measurement guidance in paragraph 470-20-35-15, an embedded feature other than the conversion option (including an embedded prepayment option) shall be considered nonsubstantive if, at issuance, the entity concludes that it is probable that the embedded feature will not be exercised. That evaluation shall be performed in the context of the convertible debt instrument in its entirety.

An issuer should consider the effect of any prepayment features, such as put and call options, on the expected life of the debt liability. The method of determining the expected life of a debt liability with puts and calls described in ASC 470-20 is to consider whether it would be rational to exercise a call (or for the investor to exercise a put) if it were embedded in a nonconvertible debt instrument with the same terms as the convertible debt instrument being evaluated. The hypothetical nonconvertible debt instrument is an instrument that (1) pays the same coupon rate as the convertible debt instrument and (2) was issued at a discount to par value, to compensate for the low coupon rate when compared to nonconvertible debt rates.

When considering puts and calls embedded in debt instruments:

- A borrower would generally not call a nonconvertible debt instrument at par with a low coupon and issued at a significant discount. Therefore, such a nonconvertible debt instrument generally has an expected life equal to its contractual life.
- Conversely, an investor would generally put a nonconvertible debt instrument with a low coupon and issued at a significant discount back to the borrower as soon as possible. Therefore, a debt instrument which the investor can put back to the issuer generally has an expected life from the issuance date to the first put date.
- A debt instrument which the reporting entity can call and the investor can put on the same date generally has an expected life equal to the period from issuance to the simultaneous put and call date.

Figure FG 6-3A provides a summary of the likely effect of put and call options on the estimated life of the convertible debt liability in applying the guidance.

### **Figure FG 6-3A**

Summary of likely effect of puts and calls on the estimated life of a nonconvertible debt instrument

| <b>Description</b>   | <b>Likely estimated life</b> |
|--|------------------------------|
| Matures in 10 years<br>Issuer call in 5 years<br>Investor put in 5 years | 5 years                      |
| Matures in 10 years<br>Issuer call in 5 years<br>Investor put in 7 years | 7 years                      |
| Matures in 10 years<br>Issuer call in 7 years<br>Investor put in 5 years | 5 years                      |
| Matures in 10 years<br>No issuer call<br>Investor put in 5 years         | 5 years                      |
| Matures in 10 years<br>Issuer call in 5 years<br>No investor put         | 10 years                     |

The expected life should not be reassessed in subsequent reporting periods.

Question FG 6-4A discusses if an issuer should consider the effect of a feature that allows an investor to put a debt instrument upon a fundamental change when determining the expected life of a convertible debt instrument within the scope of the cash conversion guidance in ASC 470-20.

## Question FG 6-4A

Should an issuer consider the effect of a feature that allows an investor to put a debt instrument upon a fundamental change (commonly referred to as a change-in-control put option) when determining the expected life of a convertible debt instrument within the scope of the cash conversion guidance in ASC 470-20?

### *PwC response*

Perhaps. The issuer should assess whether the change in control put is a substantive feature at the issuance date. If, at issuance, it is probable that an event that will trigger the change in control put will *not* occur, the change in control put should be deemed nonsubstantive and disregarded for purposes of determining the expected life. However, if the change-in-control put option is considered substantive, its effect should be considered when determining the expected life.

Figure FG 6-3A illustrates a literal application of the guidance in ASC 470-20 on determining the expected life of a debt instrument. Following this guidance can produce anomalous results. For example, applying the guidance to a convertible debt instrument with a contractual life of ten years that is puttable by the investor in year five will result in an expected life of five years. In that case, the issuer should amortize the discount created by separating the debt into its components over five years; however, investors will likely leave the debt outstanding for the full ten years because they will consider the value of the conversion option. This will result in an above market interest expense (equal to the coupon in the convertible debt and the amortization of the discount created by separating the debt into its components) over the first five years and a below market interest expense (equal to the coupon on the convertible debt) over the last five years.

### **6.6.1.2A** *Determining the nonconvertible debt rate—before adoption of ASU 2020-06*

To determine the interest rate of a similar nonconvertible debt instrument, an issuer should first consider the interest rate on its own nonconvertible debt. If that debt is similar to the convertible debt being evaluated, in terms of issuance date, tenor, and seniority, it may be appropriate to use the interest rate on its own nonconvertible debt without making any adjustments to it. If there are differences in issuance date, tenor, or seniority, an issuer should consider these differences in determining the nonconvertible debt rate.

If the issuer does not have similar nonconvertible debt, it should consider market rates for nonconvertible debt instruments with terms similar to the convertible debt being evaluated that have been issued by companies with similar credit quality to the issuer.

A reporting entity may want to consider the use of a valuation specialist to help determine the interest rate for similar nonconvertible debt instruments. This is especially true for high-yield issuers who may not have sufficient market data regarding nonconvertible debt rates available due to low credit quality.

### **6.6.2A** *Subsequent accounting—before adoption of ASU 2020-06*

As discussed in FG 6.6.1A, convertible debt with a cash conversion feature should be separated into a debt component and an equity component. FG 6.6.2.1A and FG 6.6.2.2A provide information on the amortization of the resulting debt discount and subsequent measurement requirements for a separated equity component.



### 6.6.2.1A *Amortization of debt discount—before adoption of ASU 2020-06*

The discount created by separating the convertible debt instrument into its debt and equity components should be amortized using the interest method. The amortization period should be the expected life of a similar nonconvertible debt instrument (considering the effects of any embedded features other than the conversion option, such as prepayment options). See FG 6.6.1.1A for information on determining the expected life. The amortization period is not reassessed in subsequent reporting periods.

Periodic reported interest expense for convertible debt with a cash conversion feature includes (1) the instrument's coupon and (2) the current period's amortization of the debt discount. Therefore, the accounting interest expense will be higher than the cash coupon on the convertible debt.

Question FG 6-5A discusses how a reporting entity should record interest expense on convertible debt with a cash conversion period if it remains outstanding after the debt discount amortization period.

#### **Question FG 6-5A**

A reporting entity issues convertible debt with a cash conversion feature with a term of seven years. The reporting entity decides to amortize the discount created by separating its convertible debt instrument over a period of five years because the debt is puttable by investors at the end of the fifth year.

The put is not exercised, and the debt remains outstanding after five years. How should the reporting entity record interest expense on the convertible debt instrument in years six and seven?

#### ***PwC response***

Once the debt discount recorded at issuance has been fully amortized, the reporting entity should record only the cash coupon on the convertible debt as interest expense. ASC 470-20 does not permit adjustments to the amortization period or expected life of a convertible debt instrument after issuance.

### 6.6.2.2A *Subsequent measurement of equity component—before adoption of ASU 2020-06*

The separated equity component should not be remeasured, provided it continues to meet the requirements for equity classification (i.e., it does not have to be accounted for as a derivative under the guidance in ASC 815). See FG 5.6.3A for further information on whether the instrument meets the requirements for equity classification.

#### ***Temporary (mezzanine) equity classification***

SEC registrants should present some portion of the separated equity component as temporary (or mezzanine) equity in periods in which the instrument is convertible or redeemable for cash or other assets. The amount recorded in temporary equity is equal to the amount of cash (or other assets) an investor would receive upon conversion or redemption less the amount of liability recorded for the debt component.

ASC 480-10-S99-3A provides guidance on when an instrument is considered convertible or redeemable for cash or other assets.

- Debt is currently convertible if the investor is able to exercise its conversion option and require the reporting entity to settle in cash or other assets. For contingently convertible debt, this would

- typically be the case if, at the balance sheet date, the contingency has been met. For debt without a conversion contingency, the debt may be convertible at any time. The terms of the instrument must require the reporting entity to settle in cash or other assets. If it is in the reporting entity's control to settle in cash, other assets, or equity, a portion of the separated equity component is not required to be presented as mezzanine equity.
- Debt is currently redeemable if (1) the investor holds a put option that is currently exercisable for cash or other assets or (2) the debt instrument matures in the current period.

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Question FG 6-6A addresses whether some portion of an immediately convertible cash conversion bond should be recorded as temporary equity.

### Question FG 6-6A

FG Corp issues an immediately convertible cash conversion bond with a principal amount of \$1,000. The principal amount must be settled in cash and the conversion spread in shares. Based on the guidance in ASC 470-20, FG Corp determines that the bond should be separated into a \$700 debt liability and a \$300 equity component. Should FG Corp record some portion of the \$300 equity component as temporary equity?

#### ***PwC response***

Yes. At issuance, FG Corp should record \$300 of the equity component as temporary equity. Since the bond is immediately convertible, FG Corp could be required to deliver \$1,000 of cash to the investor if they immediately convert; therefore, FG Corp should have a combined liability and temporary equity balances equal to \$1,000. As FG Corp accretes the liability balance over time (in accordance with the guidance in ASC 470-20), it should reclassify a portion of the temporary equity balance to permanent equity such that the combined liability and temporary equity balances remain equal to \$1,000.

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Although technically not required for private entities, mezzanine equity presentation is strongly encouraged, especially in those circumstances where there is not a high likelihood that the capital is in fact permanent. If mezzanine presentation is not elected, separate presentation from other items within equity should be considered.

### **6.6.3A Earnings per share—before adoption of ASU 2020-06**

Most cash conversion debt instruments are included in diluted earnings per share using a method similar to the treasury stock method described in ASC 260, *Earnings per Share* (ASC 260-10-55-84 through ASC 260-10-55-84B provide an illustration of the treasury stock method). However, when determining the earnings per share treatment of a debt instrument that may settle in any combination of cash or stock at the issuer's option, an issuer should consider the guidance on instruments settleable in cash or shares. See FSP 7.5.6.3 for information on the earnings per share treatment of cash conversion debt instruments and FSP 7.5.7.1 for information on instruments settleable in cash or shares.

#### 6.6.4A **Convertible debt with a cash conversion feature example—before adoption of ASU 2020-06**

Example FG 6-2A illustrates the initial recognition and measurement and subsequent accounting of convertible debt with a cash conversion feature.

#### **EXAMPLE FG 6-2A**

##### Accounting for convertible debt with a cash conversion feature

FG Corp (a private company) issues convertible debt that will be settled upon conversion by delivering (1) cash up to the principal amount of the debt instrument and (2) net shares equal to any value due to the conversion option being in the money. FG Corp's stock price is \$85 at the date the convertible debt is issued.

The convertible debt has the following terms:

|                       |  |
|-----------------------|--|
| Principal amount      | \$1,000  |
| Coupon rate           | 2%   |
| Years to maturity     | 7 years  |
| Issuer call option    | 2 years and thereafter   |
| Investor put option   | 5 years and thereafter   |
| Conversion Price      | \$100  |
| Conversion terms      | Investors can convert in any quarter following a quarter in which FG Corp's stock price traded at or above \$110 for at least 45 days        |
| Conversion settlement | Upon conversion, the investor will receive \$1,000 in cash and net shares equal to any value due to the conversion option being in the money |

FG Corp concludes that the debt instrument is within the scope of the cash conversion guidance in ASC 470-20 and should be separated into its debt and equity components.

FG Corp determines that a nonconvertible debt instrument with the same terms would have an expected life of five years because its debt instrument is puttable by investors at the beginning of year six. Based on its analysis of 5-year nonconvertible debt with similar terms issued by companies with similar credit quality, FG Corp determines the coupon rate for a nonconvertible debt instrument with the same terms to be 8.02%. Using a present value calculation, FG Corp determines the initial carrying value of the debt to be \$760. The proceeds allocated to the equity component is therefore \$240 (the difference between the \$1,000 proceeds and \$760 debt liability).

FG Corp develops the following schedule of balances and amortization using the beginning debt liability balance calculated using an income valuation approach and the interest method of amortization.

This example ignores the effects of income taxes.

|                                | Year 1 | Year 2 | Year 3 | Year 4 | Year 5  |
|--------------------------------|--------|--------|--------|--------|---------|
| Balance at beginning of period | \$760  | \$801  | \$845  | \$893  | \$944   |
| Amortization of discount       | 41     | 44     | 48     | 51     | 56      |
| Balance at end of period       | \$801  | \$845  | \$893  | \$944  | \$1,000 |

How should FG Corp record (1) the issuance of its convertible debt instrument and (2) amortization of the debt discount and payment of interest during the first year the debt is outstanding?

### *Analysis*

To recognize the receipt of cash and separation of the convertible debt instrument into its debt liability and residual equity components, FG Corp should record the following journal entry.

|  |  |         |         |
|--|--|---------|---------|
| Dr. Cash   |  | \$1,000 |         |
| Dr. Convertible debt discount                      |  | \$240   |         |
| Cr. Convertible debt                               |  |         | \$1,000 |
| Cr. Additional paid-in capital (conversion option) |  |         | \$240   |

To recognize the amortization of the debt discount and payment of interest during the first year the debt is outstanding, FG Corp should record the following journal entry.

|                               |  |      |      |
|-------------------------------|--|------|------|
| Dr. Interest expense          |  | \$61 |      |
| Cr. Cash                      |  |      | \$20 |
| Cr. Convertible debt discount |  |      | \$41 |

### **6.6.5A Derecognition (conversion or extinguishment) —before adoption of ASU 2020-06**

The accounting for the derecognition of convertible debt with a cash conversion feature is the same whether the debt instrument is extinguished (repurchased) or converted. In either case, the reporting entity should allocate the fair value of the consideration transferred (cash or shares) and any transaction costs incurred between (1) the debt component—to reflect the extinguishment of the debt and (2) the equity component—to reflect the reacquisition of the embedded conversion option.

An issuer should first calculate the fair value of the debt immediately prior to its derecognition. This is generally done by re-calculating the carrying value of the debt instrument using an updated remaining expected life of the debt instrument and an updated nonconvertible debt rate assumption. A gain or loss on extinguishment equal to the difference between the calculated fair value of the debt immediately prior to its derecognition and the carrying amount of the debt component, including any unamortized debt discount or issuance costs, is recorded in the income statement.

The remainder of the consideration is allocated to the reacquisition of the equity component.

If any other stated or unstated rights and privileges exist, a portion of the consideration should be allocated to those rights and privileges and accounted for according to other applicable accounting guidance.

See FG 6.9.2A for information on induced conversions of cash conversion debt.

Example FG 6-3A illustrates the derecognition of a convertible debt with a cash conversion feature.

### **EXAMPLE FG 6-3A**

#### **Derecognition of a convertible debt with a cash conversion feature**

FG Corp (a private company) issues convertible debt that will be settled upon conversion by delivering (1) cash up to the principal amount of the debt instrument and (2) net shares equal to any value due to the conversion option being in the money. FG Corp's stock price is \$85 at the date the convertible debt is issued.

The convertible debt has the following terms:

|                       |  |
|-----------------------|--|
| Principal amount      | \$1,000  |
| Coupon rate           | 2%   |
| Years to maturity     | 7 years  |
| Issuer call option    | 2 years and thereafter   |
| Investor put option   | 5 years and thereafter   |
| Conversion Price      | \$100  |
| Conversion terms      | Investors can convert in any quarter following a quarter in which FG Corp's stock price traded at or above \$110 for at least 45 days        |
| Conversion settlement | Upon conversion, the investor will receive \$1,000 in cash and net shares equal to any value due to the conversion option being in the money |

FG Corp concludes that the debt instrument is within the scope of the cash conversion guidance in ASC 470-20 and should be separated into its debt and equity components.

FG Corp determines that a nonconvertible debt instrument with the same terms would have an expected life of five years because its debt instrument is puttable by investors at the beginning of year six. Based on its analysis of 5-year nonconvertible debt with similar terms issued by companies with similar credit quality, FG Corp determines the coupon rate for a nonconvertible debt instrument with the same terms to be 8.02%. Using a present value calculation, FG Corp determines the initial carrying value of the debt to be \$760. The proceeds allocated to the equity component is therefore \$240 (the difference between the \$1,000 proceeds and \$760 debt liability).

FG Corp develops the following schedule of balances and amortization using the beginning debt liability balance calculated using an income valuation approach and the interest method of amortization.

This example ignores the effects of income taxes.

|                                | Year 1 | Year 2 | Year 3 | Year 4 | Year 5  |
|--------------------------------|--------|--------|--------|--------|---------|
| Balance at beginning of period | \$760  | \$801  | \$845  | \$893  | \$944   |
| Amortization of discount       | 41     | 44     | 48     | 51     | 56      |
| Balance at end of period       | \$801  | \$845  | \$893  | \$944  | \$1,000 |

Three years after the issuance of its convertible debt instrument, FG Corp decides to exercise its call option. FG Corp's stock price is \$125 on the date it calls its convertible debt.

Once the debt instrument is called by FG Corp, investors can either (1) convert the debt instrument and receive cash and shares with a value equal to \$1,250, which is the instrument's conversion value, or (2) choose not to convert and receive \$1,000 upon settlement of the call option. Investors choose to convert their debt instruments. FG Corp delivers \$1,000 in cash and 2 shares (worth \$125 each) for total consideration of \$1,250.

FG Corp determines that the updated expected life of the debt instrument is equal to the remaining original expected life of the debt instrument, which is two years. Based on its analysis of 5-year nonconvertible debt with two years left to maturity with similar terms issued by companies with similar credit quality, FG Corp determines the coupon rate for a nonconvertible debt instrument with the same terms to be 6.10%.

Using a present value calculation, FG Corp determines the fair value of the debt component to be \$925.

FG Corp allocates the \$1,250 consideration transferred to investors as follows (1) \$925 to extinguish the debt and (2) \$325 to reacquire the embedded conversion option.

A loss on extinguishment of \$32 is determined by calculating the difference between (1) the fair value of the debt component prior to conversion—\$925 and (2) the carrying value of the debt instrument at the end of year three—\$893 (see table above).

FG Corp's common stock has a \$1 par value.

How should FG Corp record the conversion by investors?

### *Analysis*

To record the conversion by investors, FG Corp should record the following journal entry.

|  |         |
|--|---------|
| Dr. Convertible debt                               | \$1,000 |
| Dr. Additional paid-in capital (conversion option) | \$325   |
| Dr. Loss on extinguishment of convertible debt     | \$32    |

|   |         |
|---|---------|
| Cr. Convertible debt discount                 | \$107   |
| Cr. Cash                                      | \$1,000 |
| Cr. Common stock—par value                    | \$2     |
| Cr. Additional paid-in capital (common stock) | \$248   |

## 6.7A *Beneficial conversion features—before adoption of ASU 2020-06*

A convertible debt instrument may contain a beneficial conversion feature (BCF) or contingent BCF if the conversion option is not accounted for separately. Given the number of convertible debt instruments that have separated conversion options (under the guidance in ASC 470 and ASC 815), it is unusual for a convertible debt instrument to have a BCF.

The ASC Master Glossary provides the definition of a beneficial conversion feature.

### **Definition from ASC Master Glossary**

**Beneficial Conversion Feature:** A nondetachable conversion feature that is in the money at the commitment date.

A convertible instrument contains a BCF when the conversion price is less than the fair value of the shares into which the instrument is convertible at the commitment date. See FG 7.3.2.2A for information on (1) determining the commitment date and conversion price used to assess whether a convertible instrument contains a BCF and (2) contingent BCFs.

### 6.7.1A *Resetting a conversion option for a change in stock price—before adoption of ASU 2020-06*

Some convertible instruments pay a fixed monetary amount to the investor upon conversion. To do this, the instrument's conversion price is adjusted for increases or decreases in the fair value of the reporting entity's stock. ASC 470-20-55-19 provides guidance for these instruments, which are in substance, stock-settled debt.

### **ASC 470-20-55-19**

If the conversion price was described as \$1 million divided by the market price of the common stock on the date of the conversion, that is, resetting at the date of conversion, the holder is guaranteed to receive \$1 million in value upon conversion and, therefore, there is no beneficial conversion option and the convertible instrument would be considered stock-settled debt. However, if the conversion price does not fully reset (for example, resets on specified dates before maturity), the reset represents a contingent beneficial conversion feature subject to this Subtopic.

A reporting entity should assess the reset terms of its convertible instrument to determine whether it is stock-settled debt or a convertible instrument with a contingent BCF.

**6.7.2A Measurement and recognition—before adoption of ASU 2020-06**

A BCF is measured as the intrinsic value of the conversion option at the commitment date, representing the difference between the conversion price and the reporting entity's stock price on the commitment date.

A BCF should be separated from a convertible instrument and recorded in additional paid-in capital. SEC registrants should present the BCF as mezzanine equity in periods in which it is redeemable, as described in ASC 480-10-S99-3A. The amount recorded in temporary equity is equal to the amount of cash an investor would receive upon redemption less the amount of liability recorded for the debt component.

**Excerpt from ASC 480-10-S99-3A**

...the equity-classified component of the convertible debt instrument should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash or other assets (that is, the instrument is currently redeemable or convertible for cash or other assets).

Although technically not required for nonpublic entities, mezzanine equity presentation is strongly encouraged, especially in those circumstances where there is not a high likelihood that the capital is in fact permanent, for example when the instrument is redeemable at the option of the holder at any time. On the other hand, use of a mezzanine presentation may be considered less relevant in other circumstances, such as when an instrument is redeemable by the holder only upon a remote event. If mezzanine presentation is not elected, separate presentation from other items within equity should be considered.

Separating a BCF will create a discount in the convertible debt that will result in additional interest expense.

**6.7.3A Amortization of the discount created by separating a BCF—before adoption of ASU 2020-06**

The discount on the convertible debt instrument created by separating a BCF, or contingent BCF, should be amortized over the period from the issuance date to the stated maturity date using the effective interest method; the amortization should be recognized as interest cost.

If the convertible debt is puttable by the investor prior to the first conversion date, we believe amortization of a discount created by separation of a BCF may be amortized over the period (1) from the issuance date to that first conversion date, or (2) from the issuance date to the first put date. A reporting entity should elect one of these options as an accounting policy and apply it consistently.

If a BCF is recorded on a convertible instrument with a multi-step discount, the amount of amortization recorded may require periodic adjustment to ensure that the BCF amount is at least equal to the intrinsic value the investor could realize if the instrument were converted at that point in time. See FG 7.3.2.2A for information on convertible instruments with multiple-step discounts.



**6.7.4A Conversion of convertible debt with a BCF—before adoption of ASU 2020-06**

ASC 470-20-40-1 requires a reporting entity to recognize any unamortized discount resulting from the separation of a BCF upon conversion of the instrument as interest expense. Any other unamortized discounts (e.g., created by allocating proceeds to warrants issued with the convertible instrument) should also be recognized as interest expense upon conversion. In accordance with ASC 470-20-40-2, if the amount of BCF discount amortized exceeds the amount the holder realized because conversion occurred at an earlier date, no adjustment should be made to amounts previously amortized. This guidance is unique to convertible instruments containing a BCF and should not be applied to other convertible instruments.

If a convertible instrument with a multiple-step discount is converted at a point in time when the conversion price on that date is less beneficial than the conversion price used to initially record the BCF, any previously recognized amortization of the discount created by separating the BCF should not be reversed. See FG 7.3.2.2A for information on BCFs with a multiple-step discount.

**6.7.5A Extinguishment or redemption of convertible debt with a BCF—before adoption of ASU 2020-06**

ASC 470-50-40-2 provides guidance on how to calculate a gain or loss on debt extinguishment.

**Excerpt from ASC 470-50-40-2**

A difference between the reacquisition price and the net carrying amount of the extinguished debt shall be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item.

The net carrying amount of debt includes any unamortized discount created by separating a BCF.

In addition to derecognizing the debt instrument, the reporting entity should derecognize the BCF as well. To do this, the reporting entity should perform the following steps.

- Calculate the intrinsic value (i.e., the in-the-money amount) of the conversion option at the extinguishment date and allocate that amount to additional paid-in capital to redeem the BCF
- Allocate the remainder of the reacquisition price to the extinguishment of the debt and record a gain or loss on debt extinguishment by comparing the reacquisition price allocated to the debt with the net carrying amount of the debt

See FG 3.7 for further information on debt extinguishment accounting.

**6.8A Modification of convertible debt—before adoption of ASU 2020-06**

For convertible debt, the test to determine whether a debt modification or extinguishment has occurred is more complicated than the 10% test described in FG 3.4.

ASC 470-50-40-10 prescribes a two-step approach for determining whether a convertible debt modification should be accounted for as a modification or an extinguishment.

**ASC 470-50-40-10**

From the debtor's perspective, an exchange of debt instruments between or a modification of a debt instrument by a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. If the terms of a debt instrument are changed or modified and the cash flow effect on a present value basis is less than 10 percent, the debt instruments are not considered to be substantially different, except in the following two circumstances:

- a. A modification or an exchange affects the terms of an embedded conversion option, from which the change in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is at least 10 percent of the carrying amount of the original debt instrument immediately before the modification or exchange.
- b. A modification or an exchange of debt instruments adds a substantive conversion option or eliminates a conversion option that was substantive at the date of the modification or exchange. (For purposes of evaluating whether an embedded conversion option was substantive on the date it was added to or eliminated from a debt instrument, see paragraphs 470-20-40-7 through 40-9.)

ASC 470-50-40-10 does not address legal modifications or exchanges of debt instruments in which the embedded conversion option is separated and accounted for as a derivative under ASC 815 prior to modification, subsequent to modification, or both. The accounting for these transactions depends on the specific facts and circumstances.

**6.8.1A Analysis of modifications and exchanges—before adoption of ASU 2020-06**

To determine whether a modification or exchange of a convertible debt instrument should be accounted for as a modification or an extinguishment, a reporting entity should perform a two-step analysis.

**6.8.1.1A Step 1: evaluate the change in cash flows—before adoption of ASU 2020-06**

The first step a reporting entity should perform is the 10% test discussed in FG 3.4. The 10% test should not include any changes in fair value of the embedded conversion option.

If there is an extinguishment under Step 1, there is no need to conduct the additional tests in Step 2. However, if Step 1 does not indicate an extinguishment, the reporting entity should proceed to the tests in Step 2 to determine if extinguishment accounting is required.

**6.8.1.2A Step 2: evaluate the change in the conversion option—before adoption of ASU 2020-06**

If the change in the fair value of the embedded conversion option is greater than 10% of the carrying amount of the original debt instrument immediately before the modification, the modification should be accounted for as an extinguishment. The fair value of the embedded conversion option is generally calculated using an option pricing model, such as the Black-Scholes-Merton model, based on the terms of the embedded conversion option and inputs such as market interest rates, the reporting entity's

stock price, the volatility of the reporting entity's stock price, and the expected dividend yield on the reporting entity's stock.

If the modification adds or removes a substantive conversion option from the original debt instrument, the modification should be accounted for as an extinguishment.

See FG 3.7 for information on debt extinguishment accounting. See FG 6.6.5A for information on derecognition of convertible debt with a cash conversion feature. If a modification or exchange requires the application of extinguishment accounting and the new instrument does not require or permit cash settlement upon conversion, the new instrument is no longer subject to the cash conversion guidance in ASC 470-20.

### **6.8.2A *Convertible debt modification accounting—before adoption of ASU 2020-06***

When a convertible debt instrument is modified or exchanged in a transaction that is not accounted for as an extinguishment, an increase in the fair value of the embedded, unseparated conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) should reduce the carrying amount of the convertible debt instrument (increasing debt discount or reducing debt premium) with a corresponding increase in additional paid-in capital. This additional discount should be amortized over the remaining term of the convertible debt. However, a decrease in the fair value of an embedded conversion option resulting from a modification should not be recognized.

The reporting entity should reassess the convertible debt to determine whether (1) the embedded conversion option should be separated and accounted for as a derivative under the guidance in ASC 815 or (2) it is within the scope of the cash conversion guidance in ASC 470-20. A reporting entity should not recognize a BCF or reassess an existing BCF upon a modification or exchange that is accounted for as a modification.

#### **6.8.2.1A *Modification of convertible debt with cash conversion feature—before adoption of ASU 2020-06***

When convertible debt with a cash conversion feature is modified in a transaction that is not accounted for as an extinguishment, a new effective interest rate should be determined to amortize the remaining debt discount. If the modification affects the embedded conversion option so that it no longer requires or permits cash settlement, the liability and equity components should continue to be accounted for separately.

In addition, the reporting entity should reassess the convertible debt to determine whether the embedded conversion option should be separated and accounted for as a derivative under the guidance in ASC 815. See FG 5.4.5 for further information.

## **6.9A *Conversion accounting—before adoption of ASU 2020-06***

If a convertible debt instrument accounted for entirely as a liability is converted into a reporting entity's common or preferred stock pursuant to a conversion option in the instrument, it is not an extinguishment; the convertible debt is settled in exchange for equity and no gain or loss is recognized upon conversion. Conversely, the exchange of common or preferred stock for debt that does *not*

contain a conversion right in its original terms is an extinguishment. Such an exchange may also be considered a troubled debt restructuring. See FG 3.3 for information on troubled debt restructurings.

ASC 470-20-40-4 provides guidance on accounting for conversions consistent with the original terms of a convertible debt instrument accounted for as a liability in its entirety.

#### **ASC 470-20-40-4**

If a convertible debt instrument does not include a beneficial conversion feature, the carrying amount of the debt, including any unamortized premium or discount, shall be credited to the capital accounts upon conversion to reflect the stock issued and no gain or loss is recognized.

We believe debt issuance costs should be treated similar to debt discount or premium; therefore, we believe the carrying amount should include unamortized debt issuance costs. Cash interest expense should be accrued (or imputed, in the case of a zero coupon convertible debt instrument) up to the date of conversion. If the accrued interest is not paid in cash upon conversion, then it should also be included in the carrying amount of the debt upon conversion. Interest is accrued at the pre-tax amount.

Conversion accounting is only appropriate when the conversion option has not been separated from the debt and accounted for as a derivative based on the guidance in ASC 815 or separately accounted for under the guidance in the cash conversion or beneficial conversion feature subsections of ASC 470-20.

Example FG 6-4A illustrates conversion accounting when convertible debt is accounted for entirely as a liability.

#### **EXAMPLE FG 6-4A**

##### **Conversion accounting when convertible debt is accounted for entirely as a liability**

FG Corp issues convertible debt that will be settled upon conversion entirely in shares, and concludes that the convertible debt should be accounted for as a liability in its entirety.

Debt issuance costs are \$10 and are recorded as additional debt discount on the balance sheet.

FG Corp's stock price is \$85 at the date the convertible debt is issued. FG's common stock has a par value of \$1 per share. The debt is issued at par.

The convertible debt has the following terms:

|                   |  |
|-------------------|--|
| Principal amount  | \$1,000  |
| Coupon rate       | 5% paid semi-annually on June 30 and December 31 |
| Years to maturity | 5 years  |
| Conversion price  | \$100  |

Two years after FG Corp issues the debt, investors exercise their conversion options. FG Corp's stock price is \$110 at the conversion date. FG Corp has amortized \$4 of debt issuance costs by the conversion date; therefore, there are \$6 of unamortized debt issuance costs.

This example ignores the effects of accrued interest and income taxes for simplicity.

How should FG Corp record the conversion of its convertible debt?

### *Analysis*

To derecognize the convertible debt and unamortized debt issuance costs, and recognize the common stock issued upon conversion, FG Corp should record the following entry.

|   |         |       |
|---|---------|-------|
| Dr. Convertible debt                          | \$1,000 |       |
| Cr. Deferred debt issuance costs              |         | \$6   |
| Cr. Common stock – par value                  |         | \$10  |
| Cr. Additional paid-in capital (common stock) |         | \$984 |

---

As discussed in ASC 470-20-40-5(a), the conversion of a debt instrument that becomes convertible upon the reporting entity's exercise of a call option should be accounted for using the conversion accounting model if, at issuance, the debt instrument contains a substantive conversion feature.

### **6.9.1A Conversion of debt with nonsubstantive conversion option—before adoption of ASU 2020-06**

ASC 470-20-40-5(b) provides guidance on the conversion of a debt instrument that becomes convertible upon the reporting entity's exercise of a call option when the conversion option is nonsubstantive.

#### **ASC 470-20-40-5(b)**

No substantive conversion feature. If the debt instrument did not contain a substantive conversion feature as of its issuance date (as defined in paragraphs 470-20-30-9 through 30-12), the issuance of equity securities shall be accounted for as a debt extinguishment. That is, the fair value of the equity securities issued should be considered a component of the reacquisition price of the debt.

To be considered substantive, a conversion option should be at least reasonably possible of being exercised in the future. Many conversion options meet that definition and are substantive. However, a conversion option which (1) is exercisable only upon exercise of the reporting entity's call option at par, or (2) has an extremely high conversion price relative to the price of the underlying shares at inception may not be substantive.

ASC 470-20-40-7 through ASC 470-20-40-9 provide guidance on determining whether a conversion option is substantive.

**6.9.2A Induced conversion—before adoption of ASU 2020-06**

An induced conversion is a transaction in which a reporting entity offers additional shares or other consideration (“sweeteners”) to investors to incentivize them to convert their convertible instrument. For example, a reporting entity may reduce the original conversion price or issue additional consideration (e.g., cash or warrants) not provided for in the original conversion terms to debt holders that agree to convert during a limited offer period.

ASC 470-20-40-13 and ASC 470-20-40-14 provide guidance on which transactions are induced conversions.

**ASC 470-20-40-13**

The guidance in paragraph 470-20-40-16 applies to conversions of convertible debt to equity securities pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. That guidance applies only to conversions that both:

- a. Occur pursuant to changed conversion privileges that are exercisable only for a limited period of time (inducements offered without a restrictive time limit on their exercisability are not, by their structure, changes made to induce prompt conversion)
- b. Include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted, regardless of the party that initiates the offer or whether the offer relates to all debt holders.

**ASC 470-20-40-14**

A conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt. The preceding paragraph also includes conversions pursuant to amended or altered conversion privileges on such instruments, even though they are literally provided in the terms of the debt at issuance.

ASC 470-20-40-16 requires a reporting entity to recognize an expense equal to the fair value of the shares or other consideration issued to induce conversion (i.e., the fair value of all consideration transferred in excess of the fair value of the securities transferred pursuant to the original conversion terms).

Question FG 6-7A discusses what is considered a “limited period of time” as used in ASC 470-20-40-13.

### Question FG 6-7A

What is a “limited period of time” as used in ASC 470-20-40-13?

#### ***PwC response***

We believe that when evaluating the effective time period of a change in conversion privileges, the reporting entity’s intent in offering the sweetener should be to induce prompt conversion of the convertible instrument. When this assessment is made, the inducement period should be considered in relation to the period in which the instrument is convertible without the sweetener.

Question FG 6-8A discusses whether an investor’s offer to surrender a convertible instrument in exchange for more shares of stock than it is entitled to under the original conversion terms should be accounted for as an induced conversion or extinguishment.

### Question FG 6-8A

If an investor offers to surrender a convertible instrument in exchange for more shares of stock than it is entitled to under the original conversion terms and the offer is valid for a limited period of time, should the reporting entity account for the transaction as an induced conversion or extinguishment?

#### ***PwC response***

The reporting entity should account for the transaction as an induced conversion. The party that makes the offer should not affect the accounting; thus, inducement accounting is not affected by which party makes the offer.

Question FG 6-9A discusses whether an offer to allow investors to tender their convertible instruments in exchange for cash and shares with a total value greater than the value of the shares the investor is entitled to under the original conversion terms should be accounted for as an induced conversion or as an extinguishment.

### Question FG 6-9A

A reporting entity extends an offer to investors, for a limited period of time, to allow investors to tender their convertible instruments (that contractually require gross physical settlement in shares) in exchange for cash and shares. The total value of consideration that could be received is greater than the value of the shares that the investor is entitled to under the original conversion terms; however, the number of shares the investor will receive is *less* than the number of shares it is entitled to under the original conversion terms.

Should the reporting entity account for the transaction as an induced conversion or as an extinguishment?

#### ***PwC response***

The reporting entity should account for the transaction as an extinguishment. ASC 470-20-40-13(b) requires all equity securities issuable pursuant to the original conversion privileges to be issued for the conversion to be an induced conversion. If fewer shares are issued, this condition is not met, and extinguishment accounting should be applied.

***Induced conversion—convertible debt with a cash conversion feature***

ASC 470-20-40-26 provides induced conversion guidance for convertible debt with a cash conversion feature that differs from the induced conversion guidance for other convertible instruments.

**ASC 470-20-40-26**

An entity may amend the terms of an instrument within the scope of the Cash Conversion Subsections to induce early conversion, for example, by offering a more favorable conversion ratio or paying other additional consideration in the event of conversion before a specified date. In those circumstances, the entity shall recognize a loss equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of consideration issuable in accordance with the original conversion terms. The settlement accounting (derecognition) treatment described in paragraph 470-20-40-20 is then applied using the fair value of the consideration that was issuable in accordance with the original conversion terms. **The guidance in this paragraph does not apply to derecognition transactions in which the holder does not exercise the embedded conversion option [emphasis added].**

The requirement for an investor to exercise its conversion option for a transaction to be an induced conversion conflicts with the induced conversion guidance otherwise applicable to all convertible instruments in ASC 470-20-40-14, which does *not* require the conversion option to be exercised.

**ASC 470-20-40-14**

A conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, **whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt [emphasis added]**. The preceding paragraph also includes conversions pursuant to amended or altered conversion privileges on such instruments, even though they are literally provided in the terms of the debt at issuance.

Given this conflict in the accounting literature, we believe a reporting entity should consider its specific facts and circumstances to determine whether the substance of its derecognition transaction involving convertible debt with a cash conversion feature is an induced conversion or an extinguishment. However, we believe the following transactions that are related to a limited time offer and involve additional consideration should be accounted for as induced conversions.

- Transactions in which the investor legally exercises its conversion option early (ASC 470-20-40-26)
- Transactions in which the investor does *not* exercise its conversion option, but the number of shares delivered is equal to or greater than the notional number of shares underlying the conversion option (i.e., bond principal divided by the conversion price) (ASC 470-20-40-13, ASC 470-20-40-14 and ASC 470-20-40-15)

As discussed in ASC 470-20-40-26, when a reporting entity induces conversion of convertible debt with a cash conversion feature, it should:



- Recognize an inducement charge equal to the difference between (1) the fair value of the consideration delivered to the investor and (2) the fair value of the consideration issuable under the original conversion terms
- Allocate the fair value of the consideration issuable under the original conversion terms to the debt and equity components using the derecognition guidance described in FG 6.6.5A

## **6.10A Other rights and arrangements—before adoption of ASU 2020-06**

A convertible instrument may have embedded components other than the embedded conversion option. In addition, a reporting entity may execute agreements in connection with the issuance of a convertible instrument. In the following sections we describe some of the more common embedded components and agreements.

See FG 1.7 for information on registration rights and FG 1.6.1 for information on the evaluation of embedded put and call options in debt host instruments.

### **6.10.1A Contingent interest—before adoption of ASU 2020-06**

A contingent interest feature requires additional interest to be paid only when certain conditions exist. Typically, contingent interest features are included for tax purposes to allow the reporting entity to deduct interest expense in excess of the cash coupon paid, although the extra deductions are subject to recapture. In addition, contingent interest can deter investors from exercising their put or conversion option.

A contingent interest provision in convertible debt typically requires the payment of additional interest if the instrument's average trading price is at a specified level above or below par value. For example, a provision may call for contingent interest in the amount of 25 basis points multiplied by the instrument's trading price to be paid if the average trading price is above \$120. Many contingent interest features become effective only after a simultaneous put and call date.

A contingent interest feature that meets the definition of a derivative should be considered clearly and closely related to a debt host when indexed *solely* to interest rates and credit risk. However, the trading price of a convertible debt instrument is a function of more than just interest rates and credit risk due to the embedded conversion option. As a result, contingent interest features in convertible debt instruments that are indexed to the instrument's trading price are generally not considered clearly and closely related to the debt host and should be separated and accounted for as a derivative.

The determination of the likelihood of paying contingent interest should be consistent for book and tax purposes. That is, if when determining the fair value of the bifurcated derivative for book purposes, a reporting entity determines the likelihood of payment is remote, then the same assertion should be used when determining if the interest is deductible for tax purposes. When determining the fair value of the bifurcated derivative, some reporting entities may conclude that such amount is not material because the likelihood of payment is remote. See TX 9.4.2 for information on the tax accounting considerations of contingent interest.

**6.10.2A Greenshoe (overallotment option)—before adoption of ASU 2020-06**

A greenshoe is a freestanding agreement between a reporting entity and an underwriter that allows the underwriter to call additional securities to “upsized” the amount of securities issued. These agreements are a mechanism enabling the underwriter to stabilize prices. If the convertible debt trades below the offering price, the underwriter can purchase the convertible debt for less than it was sold for, thereby decreasing supply and increasing the price. If the convertible debt trades above the offering price, the underwriter can exercise the greenshoe, thereby increasing supply and decreasing the price. For example, a 15% greenshoe on a \$100 million convertible debt offering may allow an underwriter to require the reporting entity to issue an additional \$15 million of debt at the original offering price. The term “greenshoe” comes from the name of the company (Green Shoe Manufacturing) that first used such an agreement with its underwriter.

Prior to the issuance of a convertible instrument, an underwriter will take orders from investors. The underwriter will then allocate the base amount plus any greenshoe amount to the investors. The amount allocated to investors in excess of the base amount is called an overallotment. The underwriter can fill an overallotment by exercising the greenshoe.

There are several types of greenshoes, the most common being an overallotment option. An overallotment option allows the underwriter to call additional securities from the reporting entity *only* to fill overallotments. The underwriter cannot exercise an overallotment option and hold or sell the securities for its own account. Other types of greenshoes allow the underwriter full discretion over the securities received by exercising their option.

A greenshoe on a publicly traded instrument generally will meet the definition of a derivative and, for issuances of convertible debt, will not meet the requirements for the scope exception for certain contracts involving a reporting entity’s own equity in ASC 815-10-15-74(a). As a result, a greenshoe on publicly traded debt is generally accounted for as a derivative under the guidance in ASC 815. The greenshoe is a written call option by the issuer on the convertible debt. As such, a portion of the proceeds received on the issuance of the convertible debt should be allocated to this written option based on its fair value. As a result, a discount (or a reduction of premium) will be created on the convertible debt. Since the written option meets the definition of a derivative, it should be subsequently measured at fair value, with changes in fair value recorded through earnings. Greenshoes are generally exercisable for a short period of time (typically less than 30 days) with an at-the-money strike price. As a result, greenshoes may have insignificant value.

A greenshoe on a privately placed instrument may not meet the definition of a derivative if the instrument is not readily convertible to cash. However, it is still a written call option and, as such, proceeds on the convertible debt issuance should be allocated to the greenshoe.

**6.10.3A Call option overlay—before adoption of ASU 2020-06**

A call option overlay (call spread, capped call) is a transaction executed between a reporting entity issuing a convertible debt instrument and an investment bank. In a call option overlay, the reporting entity buys a call option from the investment bank that mirrors the conversion option embedded in the convertible debt instrument, effectively “hedging” or canceling the economic effect of the embedded conversion option. The reporting entity pays a premium to the investment bank to buy this option. The reporting entity then sells a call option to the investment bank, almost always at a higher strike price than the embedded conversion option and purchased call option, effectively raising the strike price of the convertible debt instrument transaction. If the strike price of the sold call option is higher than the

strike price of the purchased call option, the reporting entity will receive a lower premium from the investment bank for selling this option.

The primary reasons a reporting entity may execute a call option overlay transaction are (1) to receive additional tax benefits and (2) to synthetically raise the strike price on the convertible debt instrument.

A call option overlay may be executed as two separate call option transactions—referred to as a call spread—or it can be executed as a single integrated transaction—referred to as a capped call. A call spread and a capped call are accounted for separately from the convertible debt instrument with which they are issued or associated. A call spread is accounted for as two transactions (1) a purchased call option on the reporting entity’s own stock and (2) a written call option on the reporting entity’s own stock at a higher strike price, whereas a capped call is accounted for as a single transaction. See FG 5.6A for information on the analysis of freestanding equity-linked instruments.

A call option overlay is included in diluted EPS based on the form of the transaction. A capped call generally is not included in diluted EPS because it is anti-dilutive. In a call spread, however, the purchased call is not included in diluted EPS because it is anti-dilutive, but the sold call is included in diluted EPS when dilutive. This can create so called “double dilution” from the convertible debt instrument and the sold call, if the reporting entity’s stock price increases to a level above the strike price on the sold call.

#### **6.10.4A Share-lending arrangements—before adoption of ASU 2020-06**

Less commonly, a reporting entity issuing a convertible debt instrument may enter into a share-lending agreement with an investment bank. A share-lending agreement is intended to facilitate the ability of investors, primarily hedge funds, to borrow shares to hedge the conversion option in the convertible debt instrument. Typically, they are executed in situations where the issuing reporting entity’s stock is difficult or expensive to borrow in the conventional stock borrow market.

The terms of a share-lending arrangement typically require the reporting entity to issue (loan) shares to the investment bank in exchange for a small fee, generally equal to the par value of the common stock. Upon conversion or maturity of the convertible debt, the investment bank is required to return the loaned shares to the reporting entity. The shares issued are legally outstanding, entitled to vote, and entitled to dividends, although under the terms of the arrangement the investment bank may agree to reimburse the issuer for dividends received and may agree not to vote on any matters submitted to a vote of the reporting entity’s shareholders.

ASC 470-20-25-20A and ASC 470-20-35-11A provide guidance on the accounting for a share-lending arrangement.

##### **ASC 470-20-25-20A**

At the date of issuance, a share-lending arrangement entered into on an entity’s own shares in contemplation of a convertible debt offering or other financing shall be measured at fair value (in accordance with Topic 820) and recognized as an issuance cost, with an offset to additional paid-in capital in the financial statements of the entity.

##### **ASC 470-20-35-11A**

If it becomes probable that the counterparty to a share-lending arrangement will default, the issuer of the share-lending arrangement shall recognize an expense equal to the then fair value of the unreturned shares, net of the fair value of probable recoveries, with an offset to additional paid-in

capital. The issuer of the share-lending arrangement shall remeasure the fair value of the unreturned shares each reporting period through earnings until the arrangement consideration payable by the counterparty becomes fixed. Subsequent changes in the amount of the probable recoveries should also be recognized in earnings.

Amortization of the discount created by the fair value of the share lending agreement which is treated as a debt issuance cost will increase the overall implied cost of the convertible debt. See FG 1.2.3 for information on the amortization of debt issuance costs.

See FSP 7.4.3.7 for information on the earnings per share treatment of share lending arrangements.

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***Chapter 7:***  
***Preferred stock—updated***  
***December 2022***

## 7.1 Preferred stock overview

This chapter discusses the accounting for preferred stock, including convertible preferred stock by the issuer. It addresses classification and measurement, the accounting for preferred stock issuance costs, participation rights, and dividends; it also discusses the accounting for modifications and extinguishments of preferred stock.

For information on common stock, see FG 4. For information on convertible debt, see FG 6 and FG 6A.

### *New guidance*

In August 2020, the FASB issued 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)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the “own stock” scope exception (see FG 5) and certain aspects of the EPS guidance.

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity’s most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

Guidance in this chapter has been updated to reflect the new ASU and impacted sections are denoted with “after adoption of ASU 2020-06” and “before adoption of ASU 2020-06.”

See FSP 5.6.4.2 for information on the disclosure requirements for preferred stock after adoption of ASU 2020-06 and FSP 5.6.4.2A for the requirements before adoption of ASU 2020-06.

## 7.2 Characteristics of preferred stock

Preferred stock (also called preferred shares or preference shares) is a class of ownership in a reporting entity that is senior to common stock and subordinate to debt. The terms of preferred stock can vary significantly. A reporting entity may issue several series of preferred stock with different features and priorities such as on dividends or assets in case of liquidation. Preferred stock may have characteristics of equity, debt, or both. Figure FG 7-1 summarizes some of the common characteristics of preferred stock.

**Figure FG 7-1**  
Characteristics of preferred stock

| <b>Feature</b>                        | <b>Overview</b>  |
|---------------------------------------|--|
| Liquidation preference                | Preferred stock holders have a claim on an issuer's assets senior to common shareholders and subordinate to bondholders and other creditors  |
| Dividends                             | Generally, preferred stock holders receive dividends before common shareholders; the dividend is typically fixed and may be cumulative or non-cumulative<br><br>Preferred stock holders may be entitled to receive additional dividends when dividends are paid to common shareholders (participating preferred stock) |
| Voting                                | Preferred stock may be voting or nonvoting; some preferred stock may have voting rights for certain extraordinary events (e.g., a takeover of the issuer, the issuance of new shares)  |
| Term                                  | Preferred stock may be perpetual, mandatorily redeemable on a specified date, or contingently redeemable either upon election of the holder, occurrence of an event, or at a point in time   |
| Conversion option                     | Convertible preferred stock either requires or permits the holder to convert the instrument into equity securities of the issuer. Some convertible preferred shares are convertible only upon the occurrence of a specified contingent event (e.g., upon an IPO)   |
| Put option exercisable by the holder  | Preferred stock may be puttable at the option of the holder after a certain period (e.g., 5 years), or upon the occurrence of an event (e.g., a change in control)   |
| Call option exercisable by the issuer | Preferred stock may be callable at the option of the issuer after a certain period or upon the occurrence of an event (e.g., a change in credit rating or change in tax or regulatory capital treatment)   |

### **7.2.1 Redemption features**

Preferred stock may or may not provide for redemption. Perpetual preferred stock does not have a redemption feature. Redeemable preferred stock may be mandatorily or contingently redeemable. The typical accounting classification for each of these types of preferred stock by the issuer is summarized in Figure FG 7-2.

**Figure FG 7-2**  
Preferred stock redemption features\*

| Type  | Liability or equity* | Mezzanine or permanent equity                                       |
|---|----------------------|---|
| Mandatorily redeemable without a substantive conversion option  | Liability            | Not applicable  |
| Mandatorily convertible into a variable number of equity shares based on a fixed monetary amount  | Liability            | Not applicable  |
| Mandatorily convertible into a variable number of equity shares when the monetary value is based on other than the fair value of the issuer's equity shares (e.g., S&P 500 index) | Liability            | Not applicable  |
| Mandatorily redeemable with a substantive conversion option   | Equity               | Mezzanine equity  |
| Redeemable (puttable) at the holder's option  | Equity               | Mezzanine equity  |
| Contingently redeemable (puttable) at the holder's option   | Equity               | Mezzanine equity  |
| Redeemable (callable) at the issuer's option  | Equity               | Permanent equity when holder does not control the board (see below) |
| Contingently redeemable (callable) at the issuer's option   | Equity               | Permanent equity  |
| No redemption (perpetual preferred stock)   | Equity               | Permanent equity  |

\* See FG 7.3.1 for more details on when preferred stock should be classified as a liability under ASC 480.

When a preferred share is redeemable (or contingently redeemable) at the option of the issuer, permanent equity classification assumes the holder does not control the board of directors (or could not control the board as a result of events outside the issuer's control, such as a debt default). In that case, the preferred shareholders, in effect, are able to force the issuer to redeem their shares for cash, which would require classification as mezzanine equity pursuant to ASC 480-10-S99. Although mezzanine equity presentation is technically not required for nonpublic entities, such presentation is strongly encouraged.

### 7.3 *Classification of preferred stock*

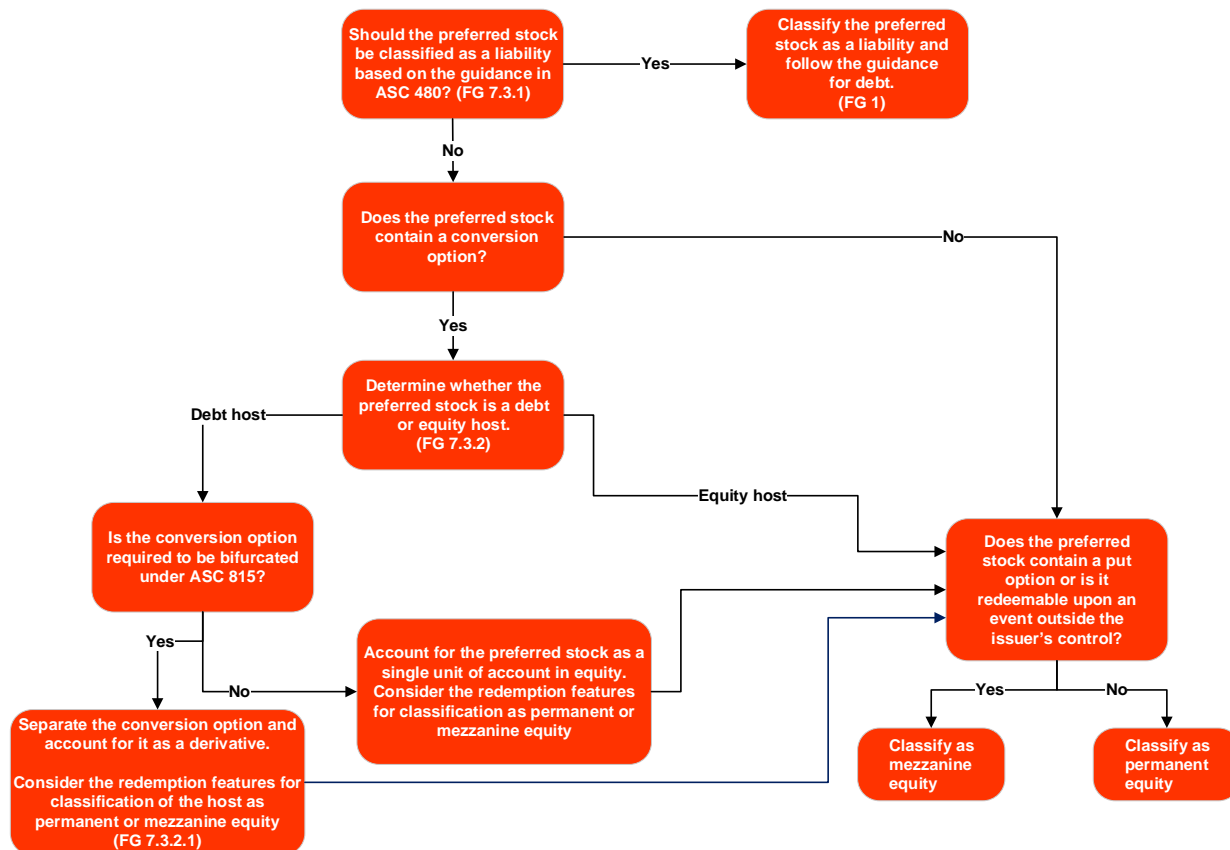
Figure FG 7-3 provides a flowchart outlining the analysis to determine the classification of and accounting for preferred stock after the adoption of ASU 2020-06. Figure FG 7-3A provides a flowchart outlining the analysis to determine the classification and accounting of preferred stock before the adoption of ASU 2020-06. Put and call options embedded in preferred stock should also be



evaluated to determine whether they should be accounted for separately as a derivative. See FG 7.3.3 for more information regarding some of the classification and accounting considerations.

### Figure FG 7-3

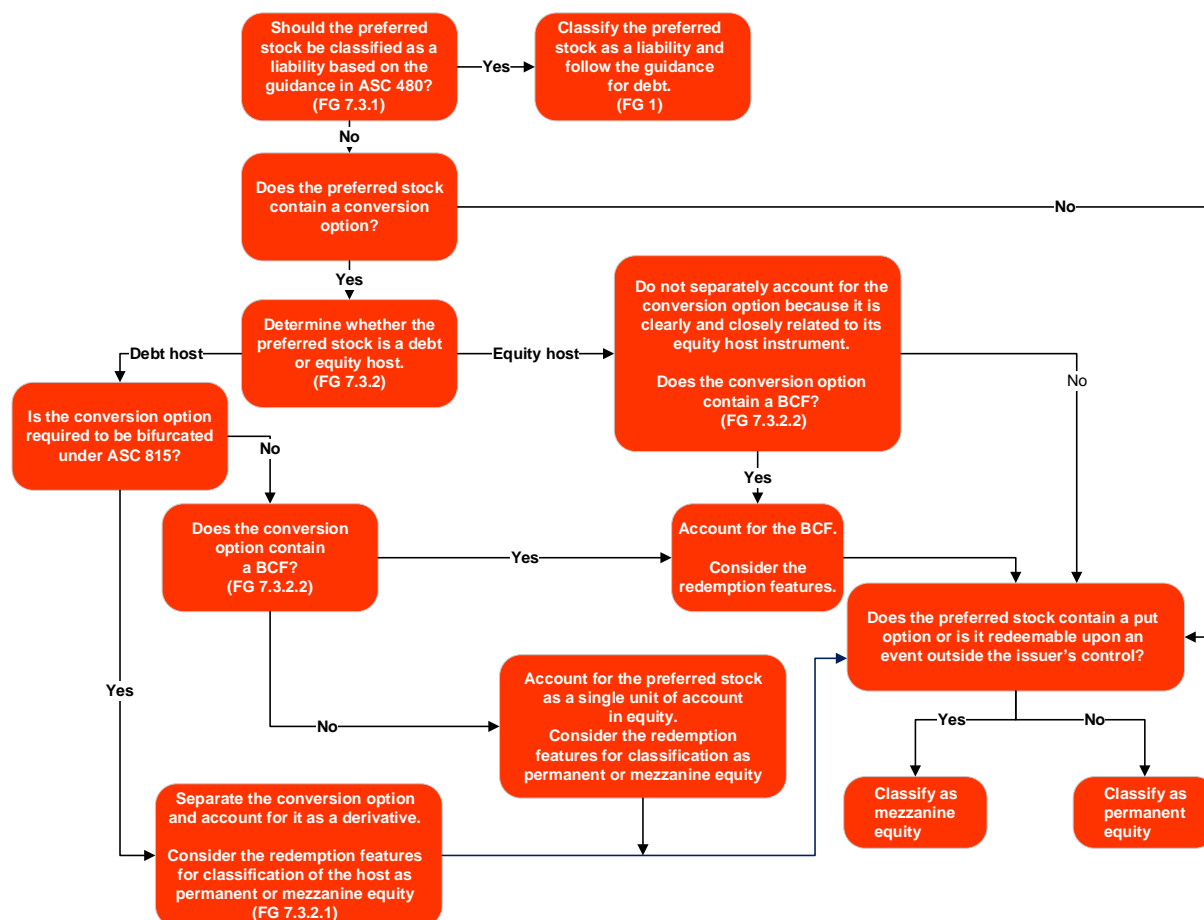
Classification and accounting treatment of preferred stock (after adoption of ASU 2020-06)



\*Note that in addition to conversion and redemption options, preferred stock instruments should be evaluated for other embedded derivatives that may require bifurcation. Refer to FG 5.4 for discussion on bifurcation of embedded features.

**Figure FG 7-3A**

Classification and accounting treatment of preferred stock (before the adoption of ASU 2020-06)



\*Note that in addition to conversion and redemption options, preferred stock instruments should be evaluated for other embedded derivatives that may require bifurcation. Refer to FG 5.4 for discussion on bifurcation of embedded features.

ASC 480, *Distinguishing Liabilities from Equity*, defines “mandatorily redeemable” financial instruments, which may include some preferred shares. At the same time, the SEC prescribes specific accounting for “preferred stock subject to mandatory redemption,” which is codified in ASC 480-10-S99. While the two terms are similar, they are not synonymous and the respective accounting treatments differ. If a preferred share meets the definition of a mandatorily redeemable financial instrument in ASC 480-10-20, the SEC guidance in ASC 480-10-S99 is not applicable.

### 7.3.1 Determine if the preferred stock is a liability under ASC 480

The first step to determine the appropriate accounting classification for preferred stock is to evaluate the instrument’s provisions to determine whether the share should be classified as a liability because it is a mandatorily redeemable financial instrument or is required to be classified as a liability based on another provision in ASC 480.

To determine whether preferred stock is a mandatorily redeemable financial instrument, all provisions that could result in the redemption of the preferred stock should be assessed. This includes provisions

labeled as a redemption feature, call option or conversion option. For example, a conversion option that requires the issuer to deliver a variable number of shares with a value equal to the redemption amount of a preferred share is, in substance, a redemption feature. See FG 7.3.1.2 for additional information about preferred stock that must be settled in a variable number of shares.

### **7.3.1.1 *Mandatorily redeemable financial instrument***

ASC 480-10-20 provides a definition of a mandatorily redeemable financial instrument, which is classified as a liability based on the guidance in ASC 480-10-25-4.

#### **Definition from ASC 480-10-20**

**Mandatorily Redeemable Financial Instrument:** Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

#### **ASC 480-10-25-4**

A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

Provisions that defer, delay, or accelerate the timing of redemption do not affect the classification of a mandatorily redeemable financial instrument as a liability, as long as the unconditional requirement to redeem the instrument remains.

Common examples of mandatorily redeemable preferred stock include the following:

- Preferred stock (nonconvertible, or convertible, if conversion option is not substantive) that must be redeemed on a specified date
- Preferred stock that must be redeemed in the event of the employee's death or termination of employment
- Preferred stock that is required to be redeemed on a specified date subject to a liquidity provision (such as a requirement to maintain adequate liquidity). A liquidity provision may affect the timing of the unconditional requirement for redemption but does not eliminate the redemption requirement.

The definition of mandatorily redeemable specifically excludes instruments that are redeemable only upon the liquidation or termination of the issuer.

Certain mandatorily redeemable financial instruments issued by nonpublic entities are not within the scope of ASC 480. See FG 5.5.1.4 for information.

### Question FG 7-1

A partnership has a life of 25 years. It issues two series of preferred stock. Series A is redeemable upon liquidation of the partnership. Series B is redeemable upon the death or termination of the partner holding the shares.

Are the Series A and Series B shares mandatorily redeemable financial instruments?

#### ***PwC response***

The Series A shares are not mandatorily redeemable financial instruments because the guidance in ASC 480-10-25-4 specifically excludes instruments redeemable only upon the liquidation or termination of the issuer.

The Series B shares may not be mandatorily redeemable because the redemption event (death or termination of the partner) may not be certain to occur within the life of the partnership (25 years). If, however, the life of the partnership is 100 years, and the partner is 50 years old, the partner's equity interest would be considered mandatorily redeemable as it is based on an event (death or termination of the partner within 100 years) that is certain to occur.

#### ***Contingently redeemable preferred stock***

Contingently redeemable preferred stock is redeemable only upon the satisfaction of a specified contingency. For example, the following instruments are contingently redeemable.

- Preferred stock that is automatically redeemed if there is a change in control or successful initial public offering
- Preferred stock that the holder has the option to redeem (e.g., preferred stock with a put option or puttable stock). In this case, the holder may or may not exercise its option

As discussed in ASC 480-10-25-7, contingently redeemable preferred stock with a substantive condition for redemption is not considered a mandatorily redeemable financial instrument until the contingency is met.

#### **ASC 480-10-25-7**

If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this Subtopic. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

Contingently redeemable preferred stock that is redeemable upon the occurrence of a nonsubstantive contingency is considered mandatorily redeemable. A conversion price that is so high relative to the current share price that the likelihood of the stock price ever reaching the conversion price is remote, is an example of a nonsubstantive condition. The determination of whether a conditional redemption

feature is substantive should generally be performed only upon issuance and should not be reevaluated. An issuer should consider reevaluation when an instrument is modified so significantly that it is considered an extinguishment of the original instrument and the issuance of a new instrument. See FG 5.5 for further information on the application of ASC 480.

In addition, preferred stock that contains a redemption provision that only affects the timing of the redemption (but does not remove the redemption requirement), such as an adequate liquidity clause or term-extending option, is also mandatorily redeemable. This preferred stock should be classified as a liability under the guidance in ASC 480.

A contingently redeemable financial instrument should be reclassified as a liability when the contingent event has occurred or becomes certain to occur, making the instrument unconditionally redeemable. The reclassification should be recorded by debiting equity and crediting a liability equal to the then current fair value of the preferred stock. The difference between the fair value and the carrying amount of the preferred stock should be subtracted from (if fair value is higher than the carrying amount) or added to (if fair value is less than the carrying amount) net income available to common shareholders when computing basic and diluted EPS as discussed in ASC 260-10-S99.

### Question FG 7-2

A reporting entity issues Series C preferred stock that is callable beginning five years after issuance and mandatorily redeemable only upon a change in control of the reporting entity. Should the reporting entity periodically reassess whether the Series C preferred stock is contingently redeemable (i.e., classified as equity) or mandatorily redeemable (i.e., classified as a liability)?

#### ***PwC response***

Yes. ASC 480 requires an issuer to assess whether an instrument is mandatorily redeemable at each reporting period. The Series C preferred stock should be initially classified as equity because redemption is conditional upon the occurrence of an event that is not certain to occur. However, upon a change in control, the Series C shares should be reclassified as a liability.

### Question FG 7-3

If an issuer calls its preferred stock on 12/15/X1 for redemption on 1/15/X2 and the call is irrevocable, should it classify the preferred stock as mandatorily redeemable in its 12/31/X1 financial statements?

#### ***PwC response***

Yes. If the call is irrevocable, the preferred stock should be reclassified as a liability until the shares are redeemed.

### ***Convertible preferred stock with mandatory redemption date***

Convertible preferred stock with a substantive conversion option and a date-certain redemption date is not mandatorily redeemable because the redemption event is not certain to occur; the conversion option could be exercised prior to the redemption date. Preferred stock that contains a conversion feature with a conversion price that is so high relative to the current share price that the likelihood of the stock price ever reaching the conversion price is remote is an example of an instrument with a

nonsubstantive conversion option. See FG 5.5.1.3 for information on nonsubstantive or minimal features.

### 7.3.1.2 **Preferred stock settled in a variable number of shares**

Convertible preferred stock may contain settlement provisions that cause it to be a liability pursuant to ASC 480. For example, a convertible preferred share that requires the delivery of a variable number of shares upon conversion could be within the scope of ASC 480-10-25-14a through ASC 480-10-25-14c. That guidance requires preferred stock that will result in the delivery of a variable number of shares that have a value solely or predominantly based (at inception) on (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares to be accounted for as a liability. See FG 5.5 for additional information on the application of ASC 480.

#### **Question FG 7-4**

Is convertible preferred stock that automatically converts into a fixed number of common shares on a specified date a liability within the scope of ASC 480?

#### ***PwC response***

No. This instrument is outside the scope of ASC 480. ASC 480-10-25-14 potentially applies only if the number of shares is variable.

#### **Question FG 7-5**

Is convertible preferred stock that automatically converts into a number of common shares with a fair value equivalent to the \$1,000,000 stated value of the preferred stock a liability within the scope of ASC 480?

#### ***PwC response***

Yes. The preferred stock converts into a variable number of shares and the monetary value of the obligation is based solely on a fixed monetary amount (stated value) known at inception. Accordingly, it should be classified as a liability under the guidance in ASC 480-10-25-14a.

#### **Question FG 7-6**

A reporting entity issues convertible preferred stock that automatically converts into a variable number of shares based on the then-current market price of the common stock. If the market price of the common stock is (1) less than \$50, the reporting entity will issue 1 share, (2) between \$50 and \$62.50, the reporting entity will issue a pro rata portion of shares between 1 share and 0.8 share equaling \$50, (3) greater than \$62.50, the reporting entity will issue 0.8 shares. Should the preferred stock be recorded as a liability within the scope of ASC 480?

#### ***PwC response***

It depends. The issuer should assess whether the settlement alternative that results in the issuance of a variable number of shares with a fixed monetary value (i.e., when the stock price is between \$50 and \$62.50) is the predominant settlement alternative at issuance of the convertible preferred stock. The

determination of predominance depends on the facts and circumstances of each transaction. See FG 5.5.1.1 for further information on the meaning of predominantly.

If the issuer determines that the monetary value of the obligation to issue common shares is based predominantly on a fixed monetary amount known at issuance, the preferred stock should be classified as a liability under the guidance in ASC 480-10-25-14a.

### Question FG 7-7

Should an issuer classify convertible preferred equity certificates (CPECs) as a liability or equity for accounting purposes?

#### ***PwC response***

CPECs are a tax efficient preferred security, generally issued from an issuer domiciled in Luxembourg. A CPEC may take various forms but is structured such that it is treated as debt for local tax purposes. Typically, a CPEC can be redeemed (i.e., matures) by the issuer 49 years after it is issued, is callable at the issuer's option at any time, has a stated yield, and is convertible into common stock at the option of the investor at any time. The conversion price approximates the fair value of the common stock on the issuance date.

While subordinate to the issuer's other debt, a CPEC has priority over share capital. A CPEC is legal form debt under local law; the holder is not entitled to any voting rights.

We believe CPECs should be classified as liabilities. The CPECs are not within the scope of ASC 480 despite the mandatory redemption date in 49 years because there is a substantive conversion option. However, because it is legal form debt, the investor is granted creditor rights, including the right to force bankruptcy; therefore, we do not believe CPECs should be classified in equity. In addition, as legal form debt, CPEC's are not considered redeemable preferred stock under ASC 480-10-S99 (i.e., they are not mezzanine equity).

#### **7.3.1.3 Preferred stock exchangeable into debt**

Some preferred stock contains a provision that requires a mandatory exchange into debt on a specified date. This feature allows the issuer to "swap" after-tax dividends for tax deductible interest payments. This type of preferred stock is a liability within the scope of ASC 480.

Preferred stock with a mandatory exchange-into-debt feature that is convertible into common shares at the option of the holder is outside the scope of ASC 480 because the holder could convert the preferred stock into common stock prior to the mandatory exchange date. This stock should be presented as mezzanine equity because it is redeemable at a fixed or determinable amount upon on an event that is outside of the issuer's control.

#### **7.3.2 Evaluate conversion options**

If preferred stock includes an embedded conversion option, the issuer must determine whether the conversion option should be separated from its host instrument and accounted for separately as a derivative. This analysis begins by determining whether the host instrument is considered to be more akin to debt or equity. An embedded conversion option is generally considered to be clearly and closely related to an equity host; it is not considered clearly and closely related to a debt host. If the host

instrument is determined to be a debt host, the issuer must then determine whether the conversion option meets the definition of a derivative and, and if so, whether the embedded conversion option qualifies for a scope exception from derivative accounting. See FG 5.4 for more information on analyzing an embedded conversion option in preferred stock including the determination as to whether the host instrument is more akin to debt or equity.

### **7.3.2.1 *Convertible instrument with a separated conversion option***

When an issuer concludes that a conversion option should be separated from its host instrument and accounted for as a derivative, it should be accounted for as a freestanding derivative instrument under the guidance in ASC 815. That is, it should be classified on the balance sheet as a derivative liability at fair value with any changes in its fair value recognized currently in the income statement. The preferred stock host should be accounted for using the guidance applicable to similar nonconvertible preferred stock. When the preferred stock host is classified as equity or mezzanine equity, the derivative liability should be presented separately from the preferred stock host on the balance sheet. When the preferred stock host is classified as a liability, it is acceptable to present the preferred stock host and the derivative liability in the same line item on the balance sheet.

ASC 815-15-30-2 through ASC 815-15-30-6 provide guidance on allocating the carrying amount of a hybrid instrument between the host contract and the derivative. That guidance requires the derivative to be initially measured at fair value, with the host contract carried at a value equal to the difference between the previous carrying amount of the hybrid instrument and the fair value of the derivative. Therefore, there is no gain or loss from the initial recognition and measurement of an embedded derivative that is accounted for separately from its host contract, except in the rare cases discussed in FG 5.4.5 when the fair value of the bifurcated derivative exceeds the net proceeds received. The allocation of proceeds to the separated derivative will typically create a discount on the associated preferred stock host instrument.

### **7.3.2.2 *Accounting for a down round—after adoption of ASU 2020-06***

Convertible preferred stock with a down round feature that is equity classified (assuming the conversion feature has not been bifurcated under ASC 815) is subject to the measurement provisions of ASC 260-10-30-1. When triggered, the value of the effect of a down round feature being triggered is recognized as a charge to retained earnings.

There are additional considerations when a down round feature is triggered in a convertible preferred security that is classified as mezzanine equity under the guidance in ASC 480-10-S99. We understand that the SEC staff has stated that the recognition of a down round feature on a mezzanine-classified convertible preferred security should be recorded as a charge to retained earnings and a credit to APIC in permanent equity and would object to a triggered down round being recorded as an adjustment to amounts reported in mezzanine equity. Since the value of the effect of a down round is reported within APIC in permanent equity and the convertible preferred stock is reported in mezzanine equity, any subsequent accretion to a redemption price under ASC 480-10-S99 would not consider the amount reported in APIC. However, amounts reported within APIC should be considered in the accounting for a redemption or extinguishment of a mezzanine-classified convertible preferred instrument. As a result, if the instrument is subsequently redeemed, amounts in APC would be considered in computing any gain or loss to be recognized upon extinguishment of the convertible preferred stock. These gains or losses may not impact earnings but may impact EPS computations. This accounting is consistent with the guidance in ASC 815-15-40-4, which addresses the extinguishment of convertible debt with a separate equity component as a result of a prior modification of the embedded conversion option, as



well as with current practice related to the redemption of convertible debt instruments issued at a substantial premium.

#### **ASC 260-10-30-1**

As of the date that a down round feature is triggered (that is upon the occurrence of the triggering event that results in a reduction of the strike price) in an equity-classified freestanding financial instrument and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) an entity shall measure the value of the effect of the feature as the difference between the following amounts determined immediately after the down round feature is triggered:

- a. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the currently stated strike price of the issued instrument (that is, before the strike price reduction)
- b. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the reduced strike price upon the down round feature being triggered.

#### **7.3.2.2A Beneficial conversion features—before adoption of ASU 2020-06**

A convertible instrument may contain a beneficial conversion feature (BCF) or a contingent BCF if the conversion option is not accounted for separately. A warrant to acquire a convertible instrument may also contain a BCF. See FG 8.2.2.5A for additional information on warrants to acquire a convertible instrument.

The ASC Master Glossary provides the definition of a beneficial conversion feature.

#### **Definition from ASC Master Glossary**

**Beneficial Conversion Feature:** A nondetachable conversion feature that is in the money at the commitment date.

A convertible instrument contains a BCF when the effective conversion price is less than the fair value of the shares into which the instrument is convertible at the commitment date. See FG 7.9.2A for information on the conversion of convertible preferred stock with a BCF.

#### ***Determining the commitment date***

The commitment date is the date on which an agreement meets the definition of a firm commitment. To have a firm commitment, an issuer must have a legally-enforceable agreement that specifies the significant terms and provides a disincentive for nonperformance that is sufficiently large to make performance probable.

ASC 470-20, *Debt with Conversion and Other Options*, provides guidance on determining a convertible instrument's commitment date.

**ASC 470-20-30-12**

If an agreement includes subjective provisions that permit either party to rescind its commitment to consummate the transaction, a commitment date does not occur until the provisions expire or the convertible instrument is issued, whichever is earlier. Both of the following are examples of subjective provisions that permit either party to rescind its commitment to consummate the transaction:

- a. A provision that allows an investor to rescind its commitment to purchase a convertible instrument in the event of a material adverse change in the issuer's operations or financial condition
- b. A provision that makes the commitment subject to customary due diligence or shareholder approval.

As a practical matter, because of clauses such as those in (a) and (b), the commitment date typically does not occur until the date the convertible instrument is issued (i.e., the date cash and securities are exchanged).

**Question FG 7-7**

When is the commitment date for convertible instruments issued under an overallotment option (greenshoe)?

***PwC response***

The commitment date for instruments issued under a greenshoe is the date the underwriter exercises its greenshoe and the securities are delivered. Prior to then, there is no commitment on the part of the underwriter to purchase the securities. It is possible for a convertible instrument that was out-of-the-money when it was priced (so that there is no beneficial conversion feature for the initial securities sold) to be in-the-money on the date the greenshoe is exercised. This would result in a BCF for the securities sold under the greenshoe. See FG 5.6.2.3A and 6.10.2A for information on greenshoes in equity offerings and convertible debt issuances, respectively.

**Question FG 7-8**

If a private reporting entity issues a convertible instrument prior to an IPO with a conversion price below the anticipated IPO price, should the reporting entity assess whether a BCF exists based on the commitment date estimated fair value of the shares or the IPO price?

***PwC response***

An issuer should consider all information available when estimating the commitment date fair value of its common stock, including the anticipated IPO price. The SEC staff has said that convertible instruments with a conversion price below the IPO price issued within one year of the filing of an initial registration statement are presumed to contain a BCF.

To overcome this presumption, an issuer would have to make an assertion that the accounting conversion price represented fair value at the commitment date (i.e., the issue date) and should ensure

that appropriate evidence exists to support that assertion. As part of this process, reporting entities should consider any valuations that an underwriter has discussed with management and/or the board of directors.

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### ***Determining the effective conversion price***

To determine whether a convertible instrument contains a BCF, an issuer should compare the conversion price and the issuer's stock price on the commitment date. The conversion price is calculated by dividing the proceeds allocated to the convertible instrument by the number of shares into which the instrument is convertible. Often, the conversion price is the same as the instrument's contractual conversion price; however, in some cases, the effective conversion price does not equal the stated conversion price. For example, when detachable warrants are issued with a convertible instrument, the issuer should allocate the proceeds between the convertible instrument and the warrants. This reduces the proceeds allocated to the convertible instrument and as a result, lowers the effective conversion price below the contractual conversion price.

Issuance costs do not affect whether an instrument contains a BCF.

### ***BCFs in instruments issued to pay dividends or interest in kind***

Some convertible instruments require or allow declared dividends or accrued interest to be paid in kind (PIK) with additional units of that convertible instrument, or a different series of convertible instruments. To determine whether a convertible instrument issued to satisfy a dividend or interest payment contains a BCF, the commitment date for the newly issued convertible instrument must be determined (see FG 7.7.2 for measurement of PIK dividends). The commitment date of the newly issued convertible instrument will ultimately depend upon whether payment in kind is discretionary or not.

ASC 470-20-30-16 through ASC 470-20-30-18 provide guidance on the commitment date for instruments that pay in kind.

#### **ASC 470-20-30-16**

If dividends or interest on a convertible instrument must be paid in kind with the same convertible instruments as those in the original issuance and are not discretionary, the commitment date for the original instrument is the commitment date for the convertible instruments that are issued to satisfy interest or dividends requirements.

#### **ASC 470-20-30-17**

For purposes of the preceding paragraph, dividends or interest are not discretionary if both of the following conditions exist:

- a. Neither the issuer nor the holder can elect other forms of payment for the dividends or interest.
- b. If the original instrument or a portion thereof is converted before accumulated dividends or interest are declared or accrued, the holder will always receive the number of shares upon conversion as if all accumulated dividends or interest have been paid in kind.

**Excerpt from ASC 470-20-30-18**

Otherwise, the commitment date for the convertible instruments issued as paid-in-kind interest or dividends is the date that the interest or the dividends are accrued and the fair value of the underlying issuer stock at the recognition or declaration date shall be used to measure the intrinsic value of the conversion option embedded in the paid-in-kind instruments.

In evaluating whether “the holder will always receive the number of shares upon conversion as if all accumulated dividends or interest have been paid in kind,” we understand that certain convertible instruments call for the forfeiture of accrued interest or dividends from the last dividend or interest payment date to the date of conversion. We believe the presence of this provision in a convertible instrument does not necessarily preclude the paid-in-kind feature from being considered “not discretionary” as long as interest or dividends when paid, are contractually required to be paid in kind. Other views may also be acceptable.

***Measurement and recognition***

A BCF is measured as the intrinsic value of the conversion option at the commitment date, representing the difference between the effective conversion price and the issuer’s stock price on the commitment date.

A BCF should be separated from a convertible instrument and recorded in additional paid-in capital. SEC registrants should present the BCF as mezzanine equity in periods in which it is redeemable, as described in ASC 480-10-S99-3A.

**Excerpt from ASC 480-10-S99-3A**

...the equity-classified component of the convertible debt instrument should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash or other assets (that is, the instrument is currently redeemable or convertible for cash or other assets).

Although technically not required for nonpublic entities, mezzanine equity presentation is strongly encouraged. See FG 7.3.4 for more information on mezzanine presentation.

Separating a BCF will create a discount in the convertible instrument which will result in additional interest expense or deemed dividends.

***Instruments with a multiple-step discount***

Some convertible instruments have a conversion price that decreases over time; this is called a multiple-step discount. ASC 470-20-30-15 provides guidance on determining the intrinsic value of a convertible instrument with a multiple-step discount.

**Excerpt from ASC 470-20-30-15**

If an instrument incorporates a multiple-step discount, the computation of the intrinsic value shall use the conversion terms that are most beneficial to the investor.

For example, assume convertible preferred stock has a conversion price of (1) \$10 at issuance, (2) \$9 six months after issuance, (3) \$8 twelve months after issuance and (4) \$7 twenty-four months after issuance. The issuer should compare the most favorable conversion price to the investor (in this example, the conversion price of \$7, twenty-four months after issuance) and compare that with the commitment date stock price to determine the BCF amount, if any.

### ***Contingently adjusting conversion prices***

Some convertible instruments have a conversion price that adjusts if certain contingent events occur. As noted in ASC 470-20-30-7, an issuer should measure a BCF using the most favorable conversion price that will be in effect at the conversion date presuming there will be no change in circumstances other than the passage of time. That is, it should not include future contingent adjustments in the measurement of the BCF but would nonetheless need to consider whether a BCF is present without the contingent adjustment.

Example FG 7-1 and Example FG 7-2 illustrate how to measure and record a BCF in convertible preferred stock issued with warrants.

### **EXAMPLE FG 7-1**

#### **BCF measurement and recognition**

FG Corp issues \$1,000 stated value convertible preferred stock and 100 detachable warrants to purchase its common stock, in exchange for \$1,000 in cash. FG Corp's stock price on the date the instruments are issued, which is the commitment date, is \$18 per share.

The convertible preferred stock has a stated conversion price of \$20; therefore, it is convertible into 50 shares of FG Corp's common stock (\$1,000 stated value / \$20 conversion price).

FG Corp concludes that the warrants meet the requirements for equity classification. Since the warrants are classified as equity, FG Corp allocates the proceeds from the issuance of the preferred stock and warrants using the relative fair value method. The sales proceeds allocated to the convertible preferred stock and warrants are \$700 and \$300, respectively.

How should FG Corp record the issuance of the convertible preferred stock and warrants?

#### *Analysis*

FG Corp should first determine whether the convertible preferred stock contains a BCF by determining the effective conversion price and comparing it to FG Corp's stock price on the commitment date.

The effective conversion price is calculated by dividing (1) the proceeds allocated to the convertible preferred stock (\$700) by (2) the number of shares into which the debt is convertible (50 shares).

$$\$700 / 50 \text{ shares} = \$14 \text{ conversion price}$$

The convertible preferred stock does contain a BCF because the \$18 commitment date stock price is greater than the \$14 effective conversion price.

The BCF is measured as the difference between the commitment date stock price (\$18) and the conversion price (\$14) multiplied by the number of shares into which the preferred stock is convertible (50 shares).

$$(\$18 - \$14) \times 50 = \$200$$

To record the issuance of the convertible debt and warrants, FG Corp should record the following journal entry.

|   |         |         |
|---|---------|---------|
| Dr. Cash  | \$1,000 |         |
| Dr. Discount on convertible preferred stock<br>(warrants) | \$300   |         |
| Dr. Discount on convertible preferred stock (BCF)         | \$200   |         |
| Cr. Convertible preferred stock                           |         | \$1,000 |
| Cr. Additional paid-in capital (warrants)                 |         | \$300   |
| Cr. Additional paid-in capital (BCF)                      |         | \$200   |

## EXAMPLE FG 7-2

### BCF measurement and recognition

FG Corp issues \$1,000 of convertible perpetual preferred stock and 100 detachable warrants to purchase its common stock in exchange for \$1,000 cash. The convertible preferred stock is convertible into 100 shares (\$1,000 convertible preferred stock / 100 shares = \$10 conversion price) immediately upon issuance. The warrants have a strike price of \$10 per share.

FG Corp's stock price on the date the instrument is issued, which is the commitment date, is \$10 per share. The fair value of the warrants on that date is \$300.

FG Corp concludes that the warrants should be classified as a liability. Since the warrants are classified as a liability, FG Corp first allocates the proceeds to the warrant based on its fair value (\$300); the remaining proceeds (\$700) are allocated to the convertible preferred stock.

How should FG Corp record the issuance of the convertible preferred stock and warrants?

#### Analysis

FG Corp should first determine whether the convertible preferred stock contains a BCF by determining the effective conversion price and comparing that to FG Corp's stock price on the commitment date.

The effective conversion price would be calculated by dividing (1) the proceeds allocated to the convertible preferred stock (\$700) by (2) the number of shares into which it is convertible (100 shares).

$$\$700 / 100 \text{ shares} = \$7 \text{ conversion price}$$

The convertible preferred stock contains a BCF because the \$10 commitment date stock price is greater than the \$7 effective conversion price.

The BCF is measured as the difference between the commitment date stock price (\$10) and the accounting conversion price (\$7) multiplied by the number of shares into which the preferred stock is convertible (100 shares).

$$(\$10 - \$7) \times 100 = \$300$$

To record the issuance of the convertible debt and warrants, FG Corp would record the following journal entry.

|  |         |         |
|--|---------|---------|
| Dr. Cash   | \$1,000 |         |
| Dr. Discount on convertible preferred stock (warrants) | \$300   |         |
| Dr. Discount on convertible preferred stock (BCF)      | \$300   |         |
| Cr. Warrant liability                                  |         | \$300   |
| Cr. Convertible preferred stock                        |         | \$1,000 |
| Cr. Additional paid-in capital (BCF)                   |         | \$300   |

Because the convertible preferred shares are perpetual (have no stated maturity date) and are convertible at any time, the discount created in the convertible preferred stock is fully amortized at issuance (i.e., recorded as a deemed dividend), thereby increasing the convertible preferred stock's carrying amount from \$400 to \$700.

|   |       |       |
|---|-------|-------|
| Dr. Retained earnings                             | \$300 |       |
| Cr. Discount on convertible preferred stock (BCF) |       | \$300 |

### ***Contingent BCFs***

An issuer may issue convertible preferred stock with a conversion price that adjusts over the term of the instrument based on a contingent event. For example, the conversion price may be reduced if the fair value of the underlying stock declines to, or below, a specified price after the commitment date.

In such situations, the issuer must determine not only whether a BCF is present at inception, but must also measure and account for the contingently adjustable conversion ratio, which is described in ASC 470-20-35-1 through ASC 470-20-35-5. Often, these adjustments decrease the instrument's conversion price, which may have the effect of creating a new BCF if one has not been previously recorded or may increase the intrinsic value of a previously recorded BCF.

ASC 470-20-25-6 provides guidance on the measurement of a contingent BCF.

**ASC 470-20-25-6**

A contingent beneficial conversion feature shall be measured using the commitment date stock price (see paragraphs 470-20-30-9 through 30-12) but, as discussed in paragraph 470-20-35-3, shall not be recognized in earnings until the contingency is resolved.

In some situations, it is not possible to measure a contingent BCF at the commitment date. For example, there may be a conversion feature that will be adjusted for the future issuance of shares at a price below the instrument's original strike price, commonly referred to as a "down-round" provision. In such situations, the contingent BCF should be measured when the contingency is resolved.

When a contingent event occurs and an instrument either becomes convertible or the conversion price is adjusted, the issuer should recalculate the BCF using the current conversion price. If the newly calculated BCF amount exceeds the previously recorded BCF, the issuer should record the additional BCF amount as an increase to additional paid-in capital.

If an instrument's conversion price increases so that the newly calculated BCF amount is less than the previously recorded BCF amount, the issuer should record the difference as a decrease to additional paid-in capital. However, any previously recognized amortization of the discount created by initially separating the BCF should not be reversed.

Example FG 7-3 illustrates how to measure and record a contingent BCF.

**EXAMPLE FG 7-3****Contingent BCF measurement and recognition**

FG Corp issues \$1,000 of convertible preferred stock in exchange for \$1,000 cash. FG Corp's stock price on the date the instrument is issued, which is the commitment date, is \$18 per share.

The convertible preferred stock has a stated conversion price of \$20 at issuance; therefore, it is convertible into 50 shares of FG Corp's common stock ( $\$1,000 \text{ preferred stock} / \$20 \text{ conversion price}$ ). The terms of the instrument include a down-round provision, requiring the conversion price to be reduced for any subsequent at market issuance of shares at a price below the instrument's original strike price.

One year after issuance, FG Corp issues shares at \$13 per share, which is the then market price for its shares. Accordingly, FG Corp reduces the instrument's conversion price to \$13; therefore, it is convertible into 77 shares of FG Corp's common stock ( $\$1,000 \text{ preferred stock} / \$13 \text{ conversion price}$ ).

No BCF existed at inception as FG Corp's stock price of \$18 was less than the conversion price of \$20.

When and how should FG Corp record the contingent BCF triggered by issuance of additional shares?

*Analysis*

The contingent BCF cannot be calculated until additional shares are issued; therefore, the contingent BCF should be measured and recorded when FG Corp issues the additional shares.



We believe the BCF amount should be calculated as the intrinsic spread between the adjusted effective accounting conversion price (\$13) and the original commitment date market price (\$18), multiplied by the new number of shares into which the security is legally convertible when the contingent event occurs (77 shares).

$$(\$18 - \$13) \times 77 \text{ shares} = \$385$$

To record the BCF, FG Corp should record the following journal entry.

|   |       |       |
|---|-------|-------|
| Dr. Discount on convertible preferred stock (BCF) | \$385 |       |
| Cr. Additional paid-in capital (BCF)              |       | \$385 |

This approach to calculating a contingent BCF (the “intrinsic method”) is referenced in ASC 470-20-55-24. However, a literal read of ASC 470-20-35-1 would indicate that the BCF amount should be calculated by multiplying the additional shares to be received once the conversion price is adjusted by the commitment date stock price. In this example, this would result in a charge of \$486 ((77 shares – 50 shares) × \$18). These methods produce the same result when the original conversion option strike price is equal to the stock price at the commitment date (i.e., the option is at the money) but produce different results when the original conversion option strike price differs from the commitment date stock price. The approach described in ASC 470-20-35-1 would result in an inaccurate contingent BCF whenever the original conversion option is issued at other than at-the-money. For that reason, we believe that the intrinsic method is more reliable.

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### ***Resetting of a conversion option for a change in stock price***

Some convertible instruments pay a fixed monetary amount to the investor upon conversion. To do this, the instrument’s conversion price is adjusted for increases or decreases in the fair value of the issuer’s stock. ASC 470-20-55-19 provides guidance for these instruments, which are in substance, stock-settled debt.

#### **ASC 470-20-55-19**

If the conversion price was described as \$1 million divided by the market price of the common stock on the date of the conversion, that is, resetting at the date of conversion, the holder is guaranteed to receive \$1 million in value upon conversion and, therefore, there is no beneficial conversion option and the convertible instrument would be considered stock-settled debt. However, if the conversion price does not fully reset (for example, resets on specified dates before maturity), the reset represents a contingent beneficial conversion feature subject to this Subtopic.

The issuer should assess the reset terms of its convertible instrument to determine whether it is stock-settled debt or a convertible instrument with a contingent BCF.

### ***Amortization of the discount created by separating a BCF***

The method of recognizing a discount created by separating a BCF, or contingent BCF, from convertible preferred stock depends on the terms of the convertible preferred stock. A BCF discount

created in an equity instrument with a stated or mandatory redemption date should be amortized over the period from the issuance date through the stated maturity or redemption date using the interest method. The amortization should be accounted for as a deemed dividend, provided the preferred stock is classified as equity.

Discounts created by separating a BCF from perpetual convertible preferred stock should be amortized over the period from the issuance date through the first date the investor can exercise the conversion option (i.e., the first conversion date) using the interest method. If preferred stock is immediately convertible, the discount should be amortized all at once upon issuance.

If the convertible preferred stock is redeemable (1) at the option of the investor or, (2) upon the occurrence of an event that is not within the issuer's control, we believe the BCF discount may be accreted over a period of time from the issuance date through (1) the first conversion date, or (2) the first put date. The amortization should be accounted for as a dividend, provided the preferred stock is classified as equity.

### **7.3.3 Evaluate put and call options**

Due to the higher cost of issuing preferred stock, it is often callable by the issuer after a certain period (e.g., after five years). In addition, put options provide holders with liquidity and protection upon the occurrence of specified events. For example, a put option exercisable upon "a fundamental change" may be included to give holders the ability to redeem their shares in certain circumstances.

Put and call options may affect the classification of preferred stock as mezzanine or permanent equity. See FG 7.3.4 for further information on classification as mezzanine or permanent equity. An issuer should also consider whether any put or call options embedded in preferred stock should be separated and accounted for as a derivative under the guidance in ASC 815. In order to assess whether a put or call option embedded in a preferred stock instrument should be bifurcated and accounted for separately, an issuer must first determine whether the preferred stock host is more akin to debt or equity. See FG 5.4.1 for information on determining the nature of the host contract.

A put or call feature embedded in preferred stock (deemed to be a debt host) will meet the definition of a derivative. See FG 1.6.1 for information on whether a put or call option embedded in a debt host must be bifurcated and accounted for separately. A put feature embedded in preferred stock (deemed to be an equity host and that is not readily convertible to cash) which requires gross physical settlement will likely not meet the definition of a derivative. As such, the embedded put feature would not require separate accounting. A put feature embedded in exchange traded preferred stock (deemed to be an equity host and that is readily convertible to cash) which requires gross physical settlement would likely meet the definition of a derivative. In this case, the issuer would need to evaluate whether the put feature meets the requirements for the scope exception for certain contracts involving an entity's own equity in ASC 815-10-15-74(a). See FG 5.4.4 for additional information on whether put and call options embedded in an equity host must be bifurcated and accounted for separately.

### **7.3.4 Preferred stock classification as mezzanine or permanent equity**

Provided preferred stock is not classified as a liability based on the guidance in ASC 480, an issuer should assess whether its preferred stock should be classified as mezzanine or permanent equity. Under the SEC rules, redeemable instruments should be presented outside of permanent equity in what is generally called the mezzanine (or temporary) equity section. The purpose of mezzanine equity classification is to convey to the financial statement users that the preferred stock may not be

permanently part of equity and could result in a demand for cash or other assets of the issuer in the future.

For SEC registrants, ASC 480-10-S99 requires preferred stock redeemable for cash or other assets to be classified outside of permanent equity (in the mezzanine or temporary equity section), if it meets any of the following conditions:

- It is redeemable at a fixed or determinable price on a fixed or determinable date
- It is redeemable at the option of the shareholder
- It is redeemable upon the occurrence of an event that is not solely within the control of the issuer

Preferred stock with mandatory redemption at a fixed or determinable date can be classified as equity if it has a substantive conversion option. See FG 5.5.1.3 for further information.

Although technically not required for private entities, mezzanine equity presentation is strongly encouraged, especially in those circumstances when there is not a high likelihood that the capital is in fact permanent, e.g., when preferred stock is redeemable at the option of the holder at any time. On the other hand, use of a mezzanine presentation may be less relevant in other circumstances, such as when preferred stock is redeemable by the holder only upon the occurrence of a remote event. If mezzanine presentation is not elected, separate presentation from other items within equity should be considered.

If preferred stock classified as mezzanine equity is no longer required to be presented in mezzanine equity (e.g., due to the expiration of a redemption feature) it should be reclassified to permanent equity. The carrying amount of the preferred stock should not be adjusted upon the reclassification to permanent equity.

As discussed in ASC 480-10-S99-3A(4), it is not appropriate to classify preferred stock that meets the requirements for classification in temporary equity as a liability.

### Question FG 7-9

An SEC registrant issues 100,000 shares of preferred stock at a \$1,000 stated value yielding proceeds of \$100 million. The preferred stock is redeemable at the option of the investor. However, the preferred stock contains a provision stipulating that the issuer can be required to redeem a maximum of \$50 million of the outstanding preferred stock. Once \$50 million of the preferred stock has been redeemed, the remaining preferred stock is no longer redeemable at the option of the investor.

Should the issuer classify \$50 million of the outstanding preferred stock in permanent equity since it cannot be required to redeem more than \$50 million of the preferred stock?

#### ***PwC response***

No. All \$100 million of the outstanding preferred stock should be classified as mezzanine equity. The guidance in ASC 480-10-S99 must be applied based on the unit of account, which is each individual share of preferred stock that has been issued. Each share of preferred stock that has been issued contains a redemption option that allows the investor to force redemption. This conclusion is

consistent with the view of the SEC staff on the classification of redeemable common shares by Special Purpose Acquisition Companies (SPACs).

### 7.3.4.1 *Contingently redeemable preferred stock*

Preferred stock that, by its terms, is contingently redeemable upon the occurrence of an event that is outside of the issuer's control should be classified as mezzanine equity based on ASC 480-10-S99. The probability that the redemption event will occur is irrelevant, as discussed in ASC 480-10-S99-3A5.

#### **Excerpt from ASC 480-10-S99-3A5**

Determining whether an equity instrument is redeemable at the option of the holder or upon the occurrence of an event that is solely within the control of the issuer can be complex. The SEC staff believes that all of the individual facts and circumstances surrounding events that could trigger redemption should be evaluated separately and that the possibility that *any* triggering event that is not *solely* within the control of the issuer could occur—without regard to probability—would require the instrument to be classified in temporary equity.

Figure FG 7-4 lists common redemption provisions that may cause preferred stock to be classified as mezzanine equity.

#### **Figure FG 7-4**

Common redemption features that may result in mezzanine equity classification

| <b>Redemption event</b>                                     | <b>Description</b>   |
|---|--|
| Delisting   | Preferred stock is redeemed in the event the issuer is delisted from trading on any stock exchange on which it is listed   |
| Decline in credit rating                                    | Preferred stock is redeemed in the event the issuer's credit rating is reduced   |
| Change of control   | Preferred stock is redeemed in the event of a change in control of the issuer, or due to a merger, consolidation, or other deemed liquidation event  |
| Failure to complete an IPO                                  | Preferred stock is redeemed if the issuer fails to complete an IPO. Completion of an IPO is outside the issuer's control   |
| Failure to have a registration statement declared effective | Preferred stock is redeemed if the issuer fails to have a registration statement declared effective by a stated date.  |
| Lapsed registration statement                               | Preferred stock is redeemed in the event an effective registration statement lapses  |
| Failure to make timely SEC filings                          | Preferred stock is redeemed in the event the issuer fails to make timely SEC filings. As stated in ASC 815-40-25-29 in the context of derivatives and hedging, the ability to make timely SEC filings is not within the issuer's control |

| <b>Redemption event</b>              | <b>Description</b>   |
|--------------------------------------|--|
| Failure to pay dividends             | Preferred stock is redeemed in the event the issuer fails to pay dividends. The ability to pay dividends may depend on the attainment of certain results (e.g., operating performance) or be restricted by the terms of loans or other securities, and therefore may not be within the issuer's control  |
| Failed Dutch Auction                 | Preferred stock sold through a Dutch Auction (auction starting with a high asking price that is subsequently lowered until a bid is made) is redeemable when there are insufficient buyers resulting in a failed auction   |
| Failure to sell an asset or division | Preferred stock is redeemable in the event the issuer fails to sell an asset or division by a certain date   |
| Covenant violations                  | Preferred stock is redeemed in the event the issuer (1) has a debt covenant violation, or (2) fails to meet a net income covenant (even if current projections indicate the occurrence of these events is remote)  |
| Key man death                        | Preferred stock is redeemable in the event of the death or disability of the CEO or other key management member, and the redemption is at the option of the holder's heir or estate.<br><br>In event the redemption will be funded from the proceeds of an insurance policy that is currently in force and that the issuer has the intent and ability to maintain in force, permanent equity classification may be permitted |

### ***Ordinary liquidation events vs. deemed liquidation events***

Ordinary liquidation events generally do not result in an instrument being classified as mezzanine equity. An instrument that is redeemable upon a deemed liquidation event, however, will often be classified as mezzanine equity. The SEC staff provides guidance on whether provisions related to a deemed liquidation event should result in a security being classified as mezzanine equity in ASC 480-10-S99-3A3(f).

#### **ASC 480-10-S99-3A3(f)**

*Certain redemptions upon liquidation events.* Ordinary 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. Other transactions are considered deemed liquidation events. For example, the contractual provisions of an equity instrument may require its redemption by the issuer upon the occurrence of a change-in-control that does not result in the liquidation or termination of the issuing entity, a delisting of the issuer's securities from an exchange, or the violation of a debt covenant. Deemed liquidation events that require (or permit at the holder's option) the redemption of only one or more particular class of equity instrument for cash or

other assets cause those instruments to be subject to ASR 268. However, as a limited exception, a deemed liquidation event does not cause a particular class of equity instrument to be classified outside of permanent equity if all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem).

In our experience, the exception discussed in ASC 480-10-S99-3A3(f) is rarely applicable. Some preferred stock agreements provide for the distribution of proceeds in the event of a deemed liquidation event (which often includes change in control) in accordance with the liquidation preferences applicable to an ordinary liquidation. Unless all holders of equally and more subordinated equity instruments *would always* be entitled to also receive the same form of consideration, we believe an instrument with this provision should be classified as mezzanine equity. In other words, for a preferred share to be classified as permanent equity, there can be no possible scenario in which the preferred shareholders are entitled to be redeemed and all subordinate classes are not also entitled to be redeemed.

### Question FG 7-10

An SEC registrant issues preferred stock that is redeemable at a stated dollar amount upon the sale, liquidation, or dissolution of the issuer. In addition, the preferred stock agreement states that the acquisition of the issuer in which the former shareholders of the issuer will own less than 50% of the voting power of the surviving entity will be deemed a sale of the issuer.

Should the preferred stock be classified as mezzanine or permanent equity?

#### ***PwC response***

The preferred stock should be classified as mezzanine equity. The shares are redeemable upon a deemed liquidation event. Since only the preferred stock (and not the common stock) will be redeemed upon the occurrence of the deemed liquidation event, and the event is not within the issuer's control, the preferred stock should be classified as mezzanine equity.

To determine whether a deemed liquidation provision causes an instrument to be classified as mezzanine equity, an issuer must have a thorough understanding of the instrument-specific definition of deemed liquidation and all of the related redemption provisions. In some cases, the issuer's governing documents or state law may require approval by the board of directors before any merger or consolidation can occur. Some might conclude that an instrument with this provision should be classified as permanent equity; however, there are often a number of other contractual "deemed liquidation events" that trigger redemption or the right to require redemption (e.g., squeeze-out mergers, hostile asset sales) that do not require board approval and thus are considered outside the control of the issuer. In that case, the preferred shares should be classified as mezzanine equity. As this is a legal determination, reporting entities should consult their legal counsel. See ASC 480-10-S99-3A8 for an example in which the SEC illustrates this point.

**ASC 480-10-S99-3A8**

A preferred security that is not required to be classified as a liability under other applicable GAAP may contain a deemed liquidation clause that provides that the security becomes redeemable if the common stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, common stock representing less than a majority of the voting power of the outstanding common stock of the surviving corporation. This change-in-control provision would require the preferred security to be classified in temporary equity if a purchaser could acquire a majority of the voting power of the outstanding common stock without company approval, thereby triggering redemption.

As stated in ASC 480-10-S99-3A5, the assessment of whether a triggering event is within the control of an issuer should be made without regard to the probability of that event occurring.

**Liquidated damages**

The terms of preferred stock may require an issuer to pay liquidated damages upon the occurrence or nonoccurrence of an event outside its control. The payment may be a significant percentage of the preferred stock proceeds. The payment of liquidated damages does not result in a legal redemption or settlement of the preferred stock; therefore, a liquidated damages provision does not cause preferred shares to be classified as mezzanine equity. However, a liquidated damages provision could be an embedded derivative that should be accounted for separately. See FG 1.6.1 for information on whether this feature in a debt host must be bifurcated and accounted for separately. See DH 4.5 for additional information on whether this feature in an equity host must be bifurcated and accounted for separately.

**7.3.4.2 Convertible preferred stock**

Contractual features, in convertible preferred stock or in the instruments into which the preferred stock may be converted, may result in the shares being classified as mezzanine equity. Figure FG 7-5 lists common features that may cause convertible preferred stock to be classified as mezzanine equity. An issuer should also consider the points discussed in FG 7.3.4.1 for contingently redeemable preferred stock and in FG 7.3.4.3 for perpetual preferred stock.

**Figure FG 7-5**

Common features that may result in mezzanine equity classification

| <b>Feature</b>                     | <b>Description</b>  |
|------------------------------------|---|
| Redemption upon conversion default | Convertible preferred stock is assumed to be redeemable in the event the issuer cannot deliver the conversion shares because (1) it does not have an adequate number of shares authorized and must seek shareholder approval for an increase to the number of authorized shares (even if the terms require that common shares be reserved for conversion and the need for an increase in authorized shares to satisfy conversion is deemed remote) or (2) delivery of the conversion shares under any circumstances would result in dilution of 20% or more of the outstanding shares of common stock, which under certain stock exchange rules requires shareholder approval prior to issuance of the conversion shares. |

| Feature  | Description  |
|--|--|
| Preferred shares exchangeable into shares of an equity-method investee or other assets             | Preferred stock is exchangeable into preferred stock of an equity-method investee of the issuer, without regard to whether the equity-method investee is a private or public entity. Preferred shares that are redeemable for cash or other assets should be reported as mezzanine equity, even when the assets to be received are not readily convertible into cash.  |
| Preferred shares convertible into mandatorily redeemable common stock                              | Preferred stock convertible into mandatorily redeemable common stock is classified as mezzanine equity because conversion of the preferred stock and redemption of the resultant common stock are both outside of the issuer's control. Once the preferred stock is converted, redemption of the common stock is certain to occur, so the common stock should be classified as a liability under the guidance in ASC 480.  |
| Convertible preferred stock when the issuer does not control share settlement of conversion option | The guidance in ASC 815-40-25 should be used to evaluate whether the issuer controls the actions or events necessary to issue the number of required shares under the conversion option if exercised by the holder. If the issuer does not control share settlement of the conversion option embedded in convertible preferred stock, then cash settlement of the conversion option would be presumed and the convertible preferred stock would be classified as temporary equity. |

### 7.3.4.3 *Perpetual preferred stock (no redemption)*

In general, perpetual preferred stock is classified as permanent equity. However, perpetual preferred stock may be classified as mezzanine equity if the preferred shareholders control the board of directors (or could control the board as a result of events outside the issuer's control, such as a debt default) and the preferred stock contains a call option exercisable at the issuer's discretion. In that case, it is assumed that the preferred shareholders would be able to force the issuer to redeem their shares for cash. In this case, mezzanine equity presentation would be appropriate.

#### **Question FG 7-11**

An SEC registrant issues preferred stock (not required to be classified as a liability) that is callable at the issuer's option at any time. The preferred security holders control a majority of the votes of the board of directors. How should the preferred stock be classified by the issuer?

#### ***PwC response***

The preferred shares should be classified as mezzanine equity. While the preferred stock is callable at the issuer's option, because the preferred shareholders control a majority of the votes of the board of directors, the guidance states (ASC 480-10-S99-3A7 *Example 2*) that the preferred security is redeemable at the option of the holder. In fact, the guidance referenced above states that if the preferred security holders control a majority of the votes of the board of directors through direct representation or through *other rights*, the preferred security is considered redeemable at the option of the holder.



### Question FG 7-12

An SEC registrant issues preferred stock (not required to be classified as a liability) that is callable at the issuer's option at any time. The preferred security holders control a majority of the votes of the board of directors (4 of 7 board seats). The governance documents indicate that the decision to call the preferred stock can be voted on only by the three director seats not controlled by the preferred shareholders. These three directors are deemed "independent" by stock exchange rules. How should the preferred stock be classified by the issuer?

#### *PwC response*

It depends. In many cases, the preferred stock is required to be classified as mezzanine equity by the issuer. Although the decision to exercise the call option is voted on only by the independent directors, the preferred stockholders still control the board of directors. If the preferred stockholders, through their board control, can remove the independent directors and replace them at their choosing, the preferred securities would still be viewed as being redeemable at the option of the investor.

We believe that all facts and circumstances must be considered when evaluating whether a preferred security (containing an issuer call option), when the investor controls the board of directors, is redeemable at the option of the investor.

## 7.4 Preferred stock recognition and measurement

Preferred stock should be recognized on its settlement date (i.e., the date the proceeds are received and the shares are issued) and is generally recorded at fair value. When preferred shares are sold in a bundled transaction with other instruments, such as warrants, the proceeds received should be allocated to the preferred stock and other instruments issued. How the proceeds are allocated depends on the accounting classification of the other instruments issued.

If the warrants are classified as equity, the proceeds should be allocated based on the relative fair values of the preferred stock instrument and the warrants. If the warrants are classified as a liability and recorded at fair value with changes in fair value recorded in the income statement, the proceeds should be allocated first to the warrants based on their fair value. The residual should be allocated to the preferred stock instrument. See FG 8.4.1 for more information on freestanding warrants issued in a bundled transaction with preferred stock.

In rare cases, the fair value of the freestanding liability-classified warrants may exceed the proceeds received in the bundled transaction. The guidance described in FG 5.4.5 related to the issuance of a hybrid instrument when the fair value of the embedded derivative liability required to be measured at fair value exceeds the net proceeds received should be applied by analogy to the bundled transaction. As a result, if the fair values are appropriate, the transaction was conducted on an arm's length basis, and there are no rights or privileges that require separate accounting recognition as an asset, the difference between the fair value of the liability-classified warrants and the net proceeds received is recognized as a day one loss in earnings. See FG 5.4.5 for additional considerations related to the application of this guidance.

If preferred stock is sold using an escrow arrangement in which cash is deposited in an escrow account for the purchase of the shares, the issuer should determine who owns the escrow account in the event of the investor's bankruptcy. If the investor's creditors have access to the escrow cash in the event of its bankruptcy, the cash held in escrow should not be recorded on the issuer's balance sheet, and if the

preferred stock is not legally owned by the investors, the preferred stock should not be recorded until the escrowed cash is legally transferred to the issuer and the shares are delivered to the investor. In these circumstances, the issuer may need to analyze the arrangement as a contract to issue shares.

Preferred shares may be sold for future delivery through a forward sale contract. In a forward sale contract, the investor is obligated to buy (and the issuer is obligated to sell) a specified number of the issuer's shares at a specified date and price. See FG 8.2.1 for information on forward sales of an issuer's own equity securities.

#### 7.4.1 **Participation rights**

One of the main disadvantages of preferred stock compared to common stock is its limited potential to benefit from increases in earnings. A participation right allows a preferred stockholder to receive additional income when dividends are paid to common shareholders.

If a preferred share host is determined to be more akin to equity than debt, a participation right is considered clearly and closely related to the host equity instrument. If the preferred stock host is more akin to debt, the participation right should be analyzed to determine if it should be separated and accounted for as a derivative under the guidance in ASC 815. See FG 5.4 for more information on analyzing an embedded equity linked component.

In addition, the inclusion of a participation right generally requires the issuer to include the instrument in earnings per share using the two-class method. See FSP 7.4.2 for information on participating securities and the two-class method of computing earnings per share.

#### 7.4.2 **Stock issuance costs**

The accounting for stock issuance costs depends on how the shares are classified on the balance sheet. Figure FG 7-6 summarizes the accounting for stock issuance costs.

**Figure FG 7-6**  
Accounting for stock issuance costs

| <b>Classification</b> | <b>Accounting for stock issuance costs</b>   |
|-----------------------|--|
| Permanent equity      | Issuance costs are recorded as a reduction of the share balance/additional paid-in capital                                 |
| Mezzanine equity      | Issuance costs are recorded as a reduction of the share balance  |
| Liability             | Issuance costs are treated in the same manner as debt issuance costs. See FG 1.2.2 for a discussion of debt issuance costs |

We believe issuance costs related to shares classified as a liability that must be accounted for at fair value (with changes in fair value recorded in the income statement) should be immediately expensed. The same treatment would apply when the issuer has elected to apply the fair value option under ASC 825.

When state regulations prohibit charging stock issuance costs to the share balance or additional paid-in capital, they may be charged to retained earnings. See FG 1.2.2 for information on qualifying issuance costs.

### Question FG 7-13

FG Corp has 120 shares outstanding owned equally by three investors. A new investor, Investor Corp, agrees to acquire 20 FG Corp shares from each of the existing investors. In connection with the transaction FG Corp agrees to reimburse the existing investors for the transaction costs related to the share sale.

How should FG Corp account for the transaction costs it pays on behalf of the existing shareholders?

#### ***PwC response***

FG Corp should carefully evaluate whether it is the counterparty to these purchase and sale transactions or if they would warrant any additional accounting. Assuming FG Corp is not required to account for the purchase and sale transactions, the sale of shares from the existing shareholders to Investor Corp does not raise capital and therefore it would be appropriate for FG Corp to expense the transaction costs it pays on behalf of the existing shareholders. However, when all shareholders participate in the sale transaction, it may also be appropriate to record the payment as a dividend, depending on the facts and circumstances of the transaction. See FG 7.7 for information on preferred stock dividends.

#### **7.4.3 *Subsequent measurement of preferred stock***

The carrying amount of preferred stock may be recorded at a discount to its redemption price. The amount the issuer must pay to redeem a preferred share may be greater than the amount at which the preferred stock was initially recorded for the following reasons:

- The preferred stock is issued in a bundled transaction with other instruments (e.g., warrants); the proceeds received by the issuer are allocated to the preferred stock and the other instruments issued
- Stock issuance costs are recorded as a reduction of the preferred stock balance
- The redemption price includes cumulative dividends whether declared or undeclared

The accounting for a preferred stock discount depends on the classification of the preferred stock and the terms of the redemption provision. See the following sections for further information.

If accretion of a preferred stock discount is required, the accretion amount should be recorded as a deemed dividend, which adjusts retained earnings (or in the absence of retained earnings, additional paid-in capital) and earnings available to common shareholders in computing basic and diluted earnings per share. See FSP 7.3 for more information on computing basic and diluted earnings per share.

### 7.4.3.1 *Liability classified preferred stock*

ASC 480-10-35-3 provides guidance on the subsequent measurement of mandatorily redeemable instruments classified as liabilities.

#### **Excerpt from ASC 480-10-35-3**

...mandatorily redeemable financial instruments shall be measured subsequently in either of the following ways:

- a. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.
- b. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

See FG 1.2.3 for information on the amortization of debt discount, premium, and issuance costs.

### 7.4.3.2 *Mezzanine classified preferred stock*

The SEC has provided guidance on the subsequent measurement of mandatorily redeemable instruments classified as mezzanine equity. The guidance is codified in ASC 480-10-S99-3A

#### **ASC 480-10-S99-3A14**

If an equity instrument subject to ASR 268 is currently redeemable (for example, at the option of the holder), it should be adjusted to its maximum redemption amount at the balance sheet date. If the maximum redemption amount is contingent on an index or other similar variable (for example, the fair value of the equity instrument at the redemption date or a measure based on historical EBITDA), the amount presented in temporary equity should be calculated based on the conditions that exist as of the balance sheet date (for example, the current fair value of the equity instrument or the most recent EBITDA measure). The redemption amount at each balance sheet date should also include amounts representing dividends not currently declared or paid but which will be payable under the redemption features or for which ultimate payment is not solely within the control of the registrant (for example, dividends that will be payable out of future earnings).

#### **ASC 480-10-S99-3A15**

If an equity instrument subject to ASR 268 is not currently redeemable (for example, a contingency has not been met), subsequent adjustment of the amount presented in temporary equity is unnecessary if it is not probable that the instrument will become redeemable. If it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), the SEC staff will not object to either of the following measurement methods provided the method is applied consistently:

- a. Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the instrument will become redeemable, if later) to the earliest

redemption date of the instrument using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates.

- b. Recognize changes in the redemption value (for example, fair value) immediately as they occur and adjust the carrying amount of the instrument to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the instrument.

As stated in ASC 480-10-S99-3A14, a redemption amount based on a formula (e.g., a multiple of trailing twelve-month EBITDA) should be calculated using the applicable information as of the balance sheet date. In this example, the reporting entity would use the trailing twelve-month EBITDA as of the balance sheet date. A reporting entity should not, for example, project the future value of the relevant metric expected as of the date of the earliest redemption.

An issuer should consider the nature of an instrument's redemption provisions when choosing the appropriate accretion method. We believe an issuer should use a method that most closely reflects the underlying economics of the instrument. For example, it may be appropriate for a preferred share redeemable at a fixed date for a fixed amount to be accreted using the method described in ASC 480-10-S99-3A15(a); however, a preferred share redeemable for a variable amount may be more appropriately measured using the method described in ASC 480-10-S99-3A15(b).

### Question FG 7-14

Is preferred stock that is both redeemable on a specified date and automatically convertible in the event of an IPO considered probable of becoming redeemable?

#### ***PwC response***

Maybe. We believe that the probability of the IPO occurring should be considered when determining whether the preferred stock is probable of becoming redeemable. Given the subjective nature of this determination, all relevant facts and circumstances should be considered.

If the preferred stock is redeemable at the option of the holder on a specified date and convertible at the option of the holder in the event of the IPO, it is inappropriate to consider the probability of the IPO occurring because the exercise of the option is controlled completely by the holder. In this case, the preferred stock should be considered probable of becoming redeemable.

### Question FG 7-15

FG Corp issued preferred stock with a stated value of \$1,000 on June 30, 20X1 that is convertible at the investor's option into a variable number of FG common shares with a fair value equal to its redemption value at any time after June 30, 20X3. The redemption value is equal to stated value plus accrued but unpaid dividends of 5%. FG Corp has classified the preferred stock as mezzanine equity because there are settlement scenarios where FG Corp may not have sufficient authorized but unissued shares to satisfy this conversion, although those scenarios are remote of occurrence. Must FG Corp accrete the preferred stock to its redemption value pursuant to ASC 480-10-S99-3A15?

**PwC response**

We believe there are two acceptable views.

□ *View A*

Once FG Corp has determined that the preferred stock is redeemable pursuant to ASC 480-10-S99-3A6, there are no contingencies to consider because the investor can force FG Corp to redeem merely through the passage of time. Therefore, FG Corp must accrete the preferred stock in accordance with ASC 480-10-S99-3A15.

□ *View B*

Although FG Corp believes there are scenarios where they must assume cash settlement, they believe potential cash settlement is contingent upon their stock price falling to a level that would require FG Corp to obtain shareholder approval to authorize additional shares. Since FG Corp believes that such an event (i.e., the stock price falling to such a level) is not probable, the preferred stock is not probable of becoming redeemable for cash or other assets, and therefore accretion to the redemption amount is not necessary.

### Question FG 7-16

FG Corp issued preferred stock with a stated value of \$1,000 on June 30, 20X1 that is convertible into FG common shares. Upon issuance, FG Corp determined that the conversion option must be bifurcated and accounted for separately as a derivative instrument pursuant to ASC 815-15-25. The preferred stock is redeemable at the option of the holder any time after June 30, 20x6. The redemption value is equal to stated value plus accrued but unpaid dividends of 5%. FG Corp has classified the preferred stock host as mezzanine equity in accordance with ASC 480-10-S99-3A. In accreting the preferred stock host to its redemption value, should FG Corp consider the liability-classified conversion option when determining the amount of accretion pursuant to ASC 480-10-S99-3A15.?

**PwC response**

Although there is no direct guidance that addresses the question, we believe that the recorded value of the separated conversion option should be considered when determining the amount of accretion pursuant to ASC 480-10-S99-3A15. This is because, in the event of redemption of the preferred stock, both the preferred stock host and the separated conversion option would be redeemed. In determining the appropriate amount of accretion, FG Corp would first measure the fair value of the separated conversion option, recording the changes in that fair value through earnings. Except as noted below, the period-end recorded value of the preferred stock host would then be determined by subtracting the fair value of the separated conversion from the redemption value of the preferred stock. The accretion amount is then determined by computing the period-end recorded value of the preferred stock host to the beginning-of-period recorded value. The preferred stock host would only be decreased to the extent of previous accretion.

Example FG 7-4 illustrates how to measure a mezzanine equity classified preferred stock instrument that is redeemable based on an index

### **EXAMPLE FG 7-4**

#### **Redeemable preferred stock based on an index**

FG Corp issued preferred stock on 1/1/20X1 at a stated value of \$1,000 that is redeemable at the option of the investor beginning on 1/1/20X6. Since the instrument is redeemable at the option of the investor, FG Corp has classified the preferred stock as mezzanine equity. The preferred stock is redeemable based on a multiple of five times trailing twelve-month EBITDA as of 1/1/20X6. FG Corp has concluded that the preferred stock is not within the scope of ASC 480-10-25-14 and that the redemption option does not need to be bifurcated from the preferred stock host.

At 12/31/20X3, five times trailing twelve-month EBITDA (based upon the trailing twelve-month EBITDA as of 12/31/20X3) yields a value of \$1,200. However, based on FG Corp's forecast of trailing twelve-month EBITDA, as of 1/1/20X6, the redemption value of the preferred stock would be \$1,500. FG Corp has made a policy election to subsequently measure the preferred stock using the methodology described in ASC 480-10-S99-3A15b.

At what amount should FG Corp measure the preferred stock instrument at 12/31/20X3?

#### *Analysis*

FG Corp would measure the preferred stock instrument at \$1,200 at 12/31/20X3 since this would be the redemption value using the conditions that exist as of the balance sheet date. ASC 480-10-S99-3A15b stipulates that, pursuant to this method, FG Corp should view the end of the reporting period as if it were also the redemption date of the instrument. As such, FG Corp would not use forecasted EBITDA to subsequently measure the instrument.

#### **7.4.3.3 Mandatorily redeemable preferred stock of a subsidiary**

If a subsidiary's preferred stock is classified as a liability in the consolidated balance sheet (e.g., pursuant to the guidance in ASC 480), the dividends and any changes in the carrying amount of the liability should be recorded as interest expense in the consolidated income statement.

If a subsidiary's preferred stock is classified as equity in the consolidated balance sheet, ASC 810-10-40-2 requires the parent to record the dividends as an allocation of net income to the noncontrolling interest. Accordingly, consolidated net income should not be reduced by dividends on the preferred stock, but net income attributable to the parent (which is the starting point for the earnings per share numerator) should be reduced by the amount of the dividend.

Example FG 7-5 illustrates the accounting for mandatorily redeemable preferred stock of a subsidiary.

### **EXAMPLE FG 7-5**

#### **Redeemable preferred stock of a subsidiary when the redemption is controlled by the issuer**

FG Corp owns 100% of the outstanding common stock of Sub Co. Sub Co has 100,000 shares of noncumulative preferred stock issued and outstanding, which pays a stated annual dividend rate of

5%. The preferred stock is owned by unrelated parties and has a recorded value of \$200,000. FG Corp analyzed the terms of Sub Co's preferred stock and concluded that the shares should be accounted for as equity in FG Corp's consolidated financial statements.

In the current year, Sub Co pays the stated annual dividend of \$10,000 ( $5\% \times \$200,000$ ). At the end of the year, Sub Co redeemed its preferred stock for \$225,000.

FG Corp has consolidated income before tax and noncontrolling interest of \$100,000, and income tax expense of \$35,000.

How should the Sub Co's preferred stock dividend and redemption be presented in FG Corp's consolidated income statement?

### *Analysis*

Since the Sub Co preferred stock is classified as equity in the FG Corp consolidated financial statements, dividends should be recorded as income attributable to the noncontrolling interest. The total dividend amount during the period is \$35,000; \$10,000 of preferred stock dividends, and a \$25,000 deemed dividend upon the redemption of the shares (\$225,000 redemption amount less \$200,000 carrying amount).

The dividend on Sub Co's preferred stock would be included in FG Corp's consolidated income statement as shown below.

|  |                        |
|--|------------------------|
| Income before tax                                      | \$100,000              |
| Income tax expense                                     | (35,000)               |
| Consolidated net income                                | <u>65,000</u>          |
| Net income attributable to the noncontrolling interest | (35,000)               |
| Net income attributable to parent                      | <u><u>\$30,000</u></u> |

#### **7.4.3.4 Contingently redeemable preferred stock**

A discount to the redemption amount of contingently redeemable preferred stock should be amortized only once it is probable the stock will become redeemable. If it is not probable that the preferred stock will become redeemable (and as a result, any discount to the preferred stock carrying amount is not amortized), an issuer should disclose the reasons why it is not probable that the instrument will become redeemable at the reporting date.

Once the security is probable of becoming redeemable, the carrying amount of the preferred stock should be accreted to its redemption value. Contingently redeemable preferred stock that is redeemable only at the issuer's option should not be adjusted (this assumes that the investor does not control the board of the company).



Figure FG 7-7 lists common redemption provisions and whether the preferred stock carrying amount should be adjusted.

### Figure FG 7-7

#### Accounting for a discount to the redemption amount of preferred stock

| Redemption provision   | Accounting for preferred stock discount   |
|--|---|
| Redeemable (puttable) at the investor's option   | The issuer has a policy choice to either (1) adjust the carrying amount of the preferred stock to its redemption amount at each balance sheet date, or (2) recognize any discount over the period from issuance to the date the preferred stock can first be redeemed. However, the carrying amount should not be adjusted to an amount that is less than the initial carrying amount. For this reason, a premium to the redemption amount should not be amortized.   |
| Callable by the issuer   | The carrying amount of the preferred stock should not be adjusted (assuming the preferred stock investor does not control the board of the company). Any premium (or discount) to the redemption amount should be recognized as a dividend upon redemption.   |
| Redeemable (automatically or at the investor's option) upon a change in control                      | The carrying amount of the preferred stock should not be adjusted until it is probable that the redemption event (a change in control) will occur. Once the occurrence of the redemption event is probable, the issuer has a policy choice to either (1) adjust the carrying amount of the preferred stock to its redemption amount at each balance sheet date, or (2) recognize any discount over the period from the date the redemption event is probable of occurring to the date the preferred stock can first be redeemed (which is likely to be a short period of time). |
| Redeemable (automatically or at the investor's option) upon a delisting of the issuer's common stock | The preferred stock carrying amount should not be adjusted until it is probable that the redemption event (delisting) will occur. Once the occurrence of the redemption event is probable, the issuer has a policy choice to either (1) adjust the carrying amount of the preferred stock to its redemption amount at each balance sheet date, or (2) recognize any discount over the period from the date the redemption event is probable of occurring to the date the preferred stock can first be redeemed (which is likely to be a short period of time).                  |

A reduction in the carrying amount of preferred stock should be recorded only to the extent the issuer previously recorded increases in the carrying amount. The accreted value of preferred stock should not be adjusted below its initial carrying amount.

An issuer should also apply the guidance in Figure FG 7-7 to determine whether unpaid cumulative dividends included in the redemption amount of contingently redeemable preferred stock should be accreted. If cumulative undeclared dividends are included in the redemption price of preferred stock that is not being adjusted, then the dividends should not be recorded until they are declared. An issuer should determine how to reflect preferred stock dividends in earnings per share independent from its accounting for cumulative preferred stock dividends. In most cases, an issuer's earnings per share

computations should reflect undeclared dividends related to cumulative preferred stock. See FSP 7.4 for information on including preferred stock dividends in basic earnings per share.

If the carrying amount of a preferred share of stock is adjusted for amortization of a discount (or for accrued but unpaid dividends), the adjustment should be recorded as a deemed dividend, which reduces retained earnings (or in the absence of retained earnings, additional paid-in capital) and earnings available to common shareholders in computing basic and diluted earnings per share.

#### **7.4.3.5 Perpetual preferred stock (no redemption)**

Perpetual preferred stock is carried at the amount recorded at inception. There is no requirement to carry perpetual preferred stock at its liquidation value; therefore, any discount or premium to the redemption amount should not be amortized. Similarly, cumulative undeclared dividends included in the redemption price of perpetual preferred stock should not be recorded until they are declared.

An issuer should determine how to reflect preferred stock dividends in earnings per share independent from its accounting for cumulative preferred stock dividends. In most cases, an issuer's earnings per share computations should reflect undeclared dividends related to cumulative preferred stock. See FSP 7.4 for information on including preferred stock dividends in basic earnings per share.

## **7.5 Increasing rate preferred stock**

Some preferred stock has a dividend that increases with the passage of time or upon the occurrence of an event outside of the issuer's control. Although there may not be a requirement to declare dividends, dividends on cumulative preferred stock should be deducted from earnings available to common shareholders when computing basic and diluted earnings per share, even if undeclared. As a result, an issuer may have an economic incentive to redeem increasing rate preferred stock to avoid the increase in the dividend rate.

The SEC staff addresses the accounting for certain nonredeemable (defined as shares that are not redeemable or redeemable only at the option of the issuer) increasing rate preferred stock in SAB Topic 5Q, which is codified in ASC 505-10-S99-7.

### **Excerpt from ASC 505-10-S99-7**

Facts: A registrant issues Class A and Class B nonredeemable preferred stock on 1/1/X1. Class A, by its terms, will pay no dividends during the years 20X1 through 20X3. Class B, by its terms, will pay dividends at annual rates of \$2, \$4 and \$6 per share in the years 20X1, 20X2 and 20X3, respectively. Beginning in the year 20X4 and thereafter as long as they remain outstanding, each instrument will pay dividends at an annual rate of \$8 per share. In all periods, the scheduled dividends are cumulative.

At the time of issuance, eight percent per annum was considered to be a market rate for dividend yield on Class A, given its characteristics other than scheduled cash dividend entitlements (voting rights, liquidation preference, etc.), as well as the registrant's financial condition and future economic prospects. Thus, the registrant could have expected to receive proceeds of approximately \$100 per share for Class A if the dividend rate of \$8 per share (the "perpetual dividend") had been in effect at date of issuance. In consideration of the dividend payment terms, however, Class A was issued for proceeds of \$79 <sup>3</sup>/<sub>8</sub> per share. The difference, \$20 <sup>5</sup>/<sub>8</sub>, approximated the value of the absence of \$8 per share dividends annually for three years, discounted at 8%.

The issuance price of Class B shares was determined by a similar approach, based on the terms and characteristics of the Class B shares.

...

Question 2: Is it acceptable to recognize the dividend costs of increasing rate preferred stocks according to their stated dividend schedules?

Interpretive Response: No. The staff believes that when consideration received for preferred stocks reflects expectations of future dividend streams, as is normally the case with cumulative preferred stocks, any discount due to an absence of dividends (as with Class A) or gradually increasing dividends (as with Class B) for an initial period represents prepaid, unstated dividend cost. Recognizing the dividend cost of these instruments according to their stated dividend schedules would report Class A as being cost-free, and would report the cost of Class B at less than its effective cost, from the standpoint of common stock interests (i.e., for purposes of computing income applicable to common stock and earnings per common share) during the years 20X1 through 20X3.

Accordingly, the staff believes that discounts on increasing rate preferred stock should be amortized over the period(s) preceding commencement of the perpetual dividend, by charging imputed dividend cost against retained earnings and increasing the carrying amount of the preferred stock by a corresponding amount. The discount at time of issuance should be computed as the present value of the difference between (a) dividends that will be payable, if any, in the period(s) preceding commencement of the perpetual dividend; and (b) the perpetual dividend amount for a corresponding number of periods; discounted at a market rate for dividend yield on preferred stocks that are comparable (other than with respect to dividend payment schedules) from an investment standpoint. The amortization in each period should be the amount which, together with any stated dividend for the period results in a constant rate of effective cost vis-a-vis the carrying amount of the preferred stock (the market rate that was used to compute the discount).

Simplified (ignoring quarterly calculations) application of this accounting to the Class A preferred stock described in the “Facts” section of this bulletin would produce the following results on a per share basis:

|           | <b>Beginning of year<br/>(BOY)</b> | <b>Imputed dividend (8% of<br/>carrying amount at BOY)</b> | <b>End of year</b> |
|-----------|------------------------------------|--|--------------------|
| Year 20X1 | 79.38                              | 6.35   | 85.73              |
| Year 20X2 | 85.73                              | 6.86   | 95.29              |
| Year 20X3 | 95.29                              | 7.41   | 100.00             |

During 20X4 and thereafter, the stated dividend of \$8 measured against the carrying amount of \$100 would reflect dividend cost of 8%, the market rate at time of issuance.

In contrast to the guidance in ASC 505-10-S99-7, if preferred stock is issued at the redemption amount, dividends should be accrued based on the payment schedule rather than amortized over the life.

### Question FG 7-17

A reporting entity issues perpetual preferred stock and receives proceeds equal to the redemption amount of the shares. The preferred stock pays an at-market cumulative dividend at a rate of 6% for the first five years and a dividend rate of 25% thereafter.

The preferred stock contains a call option that allows the issuer to call the preferred stock at par value at the end of year five before the dividend rate increases.

Is the preferred stock considered perpetual? How should the issuer accrue the dividends on the increasing rate preferred stock?

#### ***PwC response***

The preferred stock is perpetual. The shares are not redeemable even though the issuer may have an economic incentive to redeem them before the dividend rate increases and as such are not subject to ASC 480. The issuer should classify the preferred stock as permanent equity. Mezzanine equity classification is not appropriate since the investor cannot force the issuer to redeem the preferred stock.

Since the preferred stock initially pays an at-market dividend and is not issued at a discount, the dividends should be accrued based on the payment schedule. Therefore, the issuer should accrue 6% per share for the first five years and 25% thereafter until it calls the preferred stock and redeems it.

## 7.6 ***Tranched preferred stock***

A tranched preferred stock issuance is one in which preferred stock is issued with a simultaneous contractual commitment, which either (1) requires the issuer to issue additional series at a future date or upon occurrence of a specified milestone or (2) gives investors the option to require the issuer to issue additional series at a future date or upon occurrence of a specified milestone.

From the investor's perspective, tranched financing defers a portion of the cash funding. Milestones align the commitment of funds to the issuer's performance. From the issuer's perspective, tranched preferred stock reduces fundraising efforts and funding risk if the milestones are achieved.

The issuer should determine whether the commitment to issue preferred stock in the future is a freestanding instrument or a component embedded in the initial issuance. The ASC Master Glossary provides a definition of a freestanding financial instrument.

#### **Definition from ASC Master Glossary**

**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.

Since the commitment to issue preferred stock is typically entered into in connection with the issuance of the first tranche of preferred stock, an issuer should consider the provisions in (b) above by answering the following questions.

- Are the first tranche of preferred stock and the commitment to issue shares legally detachable?
- Are the first tranche of preferred stock and the commitment to issue shares separately exercisable?

As discussed in FG 5.3, we believe separate exercisability is a strong indicator that a component is freestanding because a component must first be detached from its host instrument (i.e., the preferred stock) before it can be separately exercised. However, some issuers put more weight on whether the commitment to issue shares is legally detachable from the first tranche of preferred stock when determining whether it is freestanding or embedded. Generally, if the transaction documents do not specifically state that the commitment cannot be transferred separate from the preferred stock, the commitment is considered freestanding. See FG 5.3 for additional information on determining whether an instrument is freestanding or embedded.

An issuer's accounting for the commitment to issue additional preferred stock may differ if it is a freestanding instrument versus embedded in the originally issued preferred stock.

#### **7.6.1 *Commitment to issue shares is a freestanding instrument—after adoption of ASU 2020-06***

If a commitment to issue additional preferred stock is a freestanding instrument, the issuer should determine the appropriate classification of that freestanding commitment. The classification affects the methodology for allocating the proceeds received to the originally issued preferred stock and the commitment to issue additional preferred stock.

The commitment to issue additional preferred stock should first be evaluated to determine whether it is a liability within the scope of ASC 480. See FG 5.5 for information on ASC 480. If it is not within the scope of ASC 480, it should be evaluated using the model for freestanding equity-linked instruments discussed in FG 5.6.

If an issuer determines that a commitment to issue additional preferred stock should be classified as equity, the proceeds from the original issuance should be allocated to the originally issued preferred stock and the commitment to issue additional preferred stock using the relative fair value method. The commitment to issue additional preferred stock should not be subsequently remeasured if it is classified as equity.

When an issuer determines that a commitment to issue additional preferred stock meets the definition of a derivative, or determines that it does not meet the requirements for equity classification and does not meet the definition of a derivative, the proceeds from the original issuance should be first allocated to that commitment at fair value, with any remainder allocated to the originally issued preferred stock. The commitment to issue additional preferred stock should be subsequently recorded at fair value with changes in fair value recorded in the income statement. See FG 5.6 for further information.

The allocation of value to a commitment to issue additional preferred stock may create a discount from the redemption amount of the originally issued preferred stock, which may have to be amortized. See FG 7.4.3 for information on the subsequent measurement of preferred stock, including the amortization of a discount.

### **7.6.1A *Commitment to issue shares is a freestanding instrument—before adoption of ASU 2020-06***

If a commitment to issue additional preferred stock is a freestanding instrument, the issuer should determine the appropriate classification of that freestanding commitment. The classification affects the methodology for allocating the proceeds received to the originally issued preferred stock and the commitment to issue additional preferred stock.

The commitment to issue additional preferred stock should first be evaluated to determine whether it is a liability within the scope of ASC 480. See FG 5.5 for information on ASC 480. If it is not within the scope of ASC 480, it should be evaluated using the model for freestanding equity-linked instruments discussed in FG 5.6.

If an issuer determines that a commitment to issue additional preferred stock should be classified as equity, the proceeds from the original issuance should be allocated to the originally issued preferred stock and the commitment to issue additional preferred stock using the relative fair value method. The commitment to issue additional preferred stock should not be subsequently remeasured if it is classified as equity.

If an issuer determines that a commitment to issue additional preferred stock should be classified as a derivative, the proceeds from the original issuance should be first allocated to that commitment at fair value, with any remainder allocated to the originally issued preferred stock. The commitment to issue additional preferred stock should be subsequently recorded at fair value with changes in fair value recorded in the income statement.

If the commitment to issue additional preferred stock does not meet the requirements for equity classification and does not meet the definition of a derivative, the issuer should record the commitment as an asset or a liability and subsequently measure using appropriate US GAAP. See FG 5.6A for further information.

The allocation of value to a commitment to issue additional preferred stock may create a discount from the redemption amount of the originally issued preferred stock, which may have to be amortized. See FG 7.4.3 for information on the subsequent measurement of preferred stock, including the amortization of a discount.

### **7.6.2 *Commitment to issue shares is an embedded component***

If the commitment to issue additional preferred stock is an embedded component, it should be evaluated to determine whether it should be bifurcated from its host and separately accounted for as a derivative based on the guidance in ASC 815. See FG 5.4 for the model for analyzing embedded equity-linked components. If an embedded commitment to issue additional preferred stock should be separated and accounted for as a derivative, a discount from the redemption amount of the preferred stock will be created, which may have to be amortized. See FG 7.4.3 for information on the subsequent measurement of preferred stock, including the amortization of a discount.

## **7.7 *Preferred stock dividends***

Noncumulative dividends on preferred stock generally do not accrue to the holders of preferred stock until declared by the board of directors. The exception is when preferred stock requires the issuer to

pay a periodic dividend even without a declaration by the board of directors. When noncumulative dividends are discretionary, they should be recorded when they are declared. When the issuer is legally obligated to pay dividends, they should be accrued as they are earned. Noncumulative dividends, generally, do not add to the liquidation or redemption value of preferred stock.

Cumulative dividends on preferred stock may accrue over time or upon the occurrence of an event (e.g., the attainment of cash flow goals or profitability levels). If the preferred shareholders do not receive a dividend (the board of directors does not declare a dividend) in a given period, then the undeclared dividend is accumulated. The issuer is obligated to pay any accumulated undeclared dividends upon liquidation and, in some cases, upon early redemption of the preferred stock. Some preferred stock requires the issuer to pay a periodic dividend even without a declaration by the board of directors. When cumulative dividends can be accumulated (or deferred), they should be recorded when they are declared or when accretion to the redemption amount is otherwise required. Alternatively, when the issuer is legally obligated to pay cumulative dividends, they should be accrued as they are earned.

When preferred shareholders participate in dividends with common shareholders, the two-class method of computing earnings per share may be applicable. See FSP 7.4.2 for information on participating securities and the two-class method of calculating earnings per share.

An issuer should determine how to reflect preferred stock dividends in earnings per share independent from its accounting for cumulative preferred stock dividends. In most cases, an issuer's earnings per share computations should reflect accrued undeclared dividends related to cumulative preferred stock. See FSP 7.4 for information on including preferred stock dividends in basic earnings per share.

See FG 4.4 for additional information on dividends.

### Question FG 7-18

A reporting entity issues preferred stock that pays cumulative dividends and is redeemable at the holder's option after four years. The redemption price is equal to the original issue price plus the cumulative dividends, whether or not declared. The issuer classifies the preferred stock in mezzanine equity because it is not mandatorily redeemable (i.e., the holders may or may not exercise the redemption right) but redemption is outside of the issuer's control.

Should dividends be recorded as an increase to the carrying amount of the preferred stock even when not declared?

#### ***PwC response***

Yes. Generally, an issuer records a dividend payable when the dividend is declared. However, the terms of the preferred stock require the issuer to pay the original issue price of the preferred stock plus cumulative dividends, whether or not declared, upon redemption. Therefore, the issuer should accrete the dividends as an increase to the carrying amount of the preferred stock pursuant to ASC 480-10-S99-3A, despite the fact that dividends have not been declared.

#### **7.7.1 Dividends paid in another class of stock**

When a stock dividend on preferred shares is paid in another class of stock, the issuer should record the fair value of the shares issued in retained earnings. See FG 4.4.4.1 for further information. As

discussed in ASC 260-10-45-12, dividends declared on preferred stock that are payable in the issuer's common shares should be deducted from earnings available to common shareholders when computing earnings per share. Accordingly, an adjustment to net income (for EPS purposes) for preferred stock dividends is required regardless of the form of the payment (whether the dividend is paid in cash, common shares, or additional preferred shares of the same or another class).

### **7.7.2 *PIK dividends***

Some preferred stock includes a paid-in-kind dividend feature (where dividends are paid in shares of the same class of stock). This preferred stock may either require the issuer to pay the dividend in additional shares of stock (nondiscretionary PIK dividend) or allow the issuer to choose between paying the dividend in additional shares of stock or in cash (discretionary PIK dividend). For example, an issuer may issue 10,000 shares of convertible preferred stock with a liquidation preference of \$1,000/share that carries a 10% stated dividend rate, payable semi-annually. Typically, if the dividend were to be PIK, the issuer would issue on each dividend payment date 500 additional shares of convertible preferred stock with a liquidation preference of \$500,000. We believe the issuer should record the PIK dividend as follows:

- If the issuer has the right to decide whether to pay the PIK dividend in cash or in kind (PIK dividends are discretionary), the issuer should record the PIK dividend at the fair value of the preferred stock at the dividend declaration date.
- If the issuer is required to pay the dividend in kind (PIK dividends are non-discretionary), the issuer should record the PIK dividend on the declaration date at the contractual rate (\$500,000 in this example). This results in accretion of the dividend similar to the amortization of interest on a zero-coupon bond.

## **7.8 *Preferred stock modifications***

There is no specific guidance on whether a modification to, or exchange of, preferred stock should be accounted for as a modification or an extinguishment. Many preferred stock modifications do not involve changes in cash flows, but may result in a significant change to the fair value of the security, such as a change in the liquidation preference order/priority, voting rights, or conversion ratio. As such, the accounting for preferred stock modifications depends on the facts and circumstances of each transaction, including the nature of, and reasons for, the modification.

### **7.8.1 *Determining the accounting for a modification***

When an issuer changes the terms of its preferred stock or exchanges shares of preferred stock for another, it must assess whether the changes or exchange should be accounted for as either a modification or an extinguishment. This assessment can be done either qualitatively or quantitatively. A qualitative assessment is generally appropriate when the changes to a preferred stock instrument are either so inconsequential or so significant that an issuer can easily determine how a change to or exchange of shares should be accounted for without performing a quantitative test. For example, administrative changes to a preferred stock would likely be accounted for as a modification; a modification of preferred stock to include a substantive conversion option would generally be accounted for as an extinguishment of the original preferred stock and issuance of new preferred stock. When preferred stock is modified in a manner that cannot be reliably assessed qualitatively, an



issuer should perform a quantitative test to determine whether the modification or exchange should be accounted for as a modification or an extinguishment.

When preferred stock has well-defined periodic contractual cash flows, an issuer may apply the cash flow model used to assess debt modifications in ASC 470-50, *Debt – Modifications and Extinguishments*, to determine whether a modification or exchange of preferred stock should be accounted for as a modification or extinguishment. Under that model, an issuer would compare the present value of the contractual cash flows (calculated using the effective interest rate of the original instrument) before and after a modification or exchange. If the present value of the contractual cash flows is 10% or more, the modification or exchange is accounted for as an extinguishment; if the present value of the contractual cash flows differs by less than 10%, the modification or exchange is accounted for as a modification. See FG 3.4 for further information on the cash flow model in ASC 470-50.

If preferred stock has characteristics that cannot be reliably assessed using the cash flow model in ASC 470-50, it should be evaluated using another quantitative model, such as the fair value model. Under the fair value model, an issuer would compare the fair value of the preferred stock immediately before and after the modification or exchange. If the fair value before and after the modification or exchange are substantially different, the modification or exchange should be accounted for as an extinguishment; if the fair value before and after the modification or exchange are not substantially different, it should be accounted for as a modification. In practice, “substantially different” has typically been interpreted to be a 10% or more change in fair value.

### Question FG 7-19

If an issuer redeems existing preferred stock and issues new preferred stock to the same investors (e.g., exchanges Series A preferred stock for Series B preferred stock), should it be automatically accounted for as an extinguishment?

#### ***PwC response***

No. The legal extinguishment of existing preferred stock that is replaced with new preferred stock does not automatically result in extinguishment accounting. An issuer should assess, using one of the methods described in this section, whether the exchange should be accounted for as a modification or an extinguishment.

### **7.8.2 Accounting for a preferred stock modification**

If the assessment results in an extinguishment, then the difference between the consideration paid (i.e., the fair value of the new or modified preferred stock) and the carrying value of the original preferred stock should be recognized as a reduction of, or increase to, retained earnings as a deemed dividend. It should also be recognized as an adjustment to earnings available to common shareholders for purposes of calculating earnings per share. See FG 7.10 for information on the extinguishment of preferred stock.

If an issuer determines that an exchange or modification of preferred stock should be accounted for as a modification, it should then evaluate whether the original preferred shareholders paid or received a dividend through the new (or modified) terms. The issuer should measure any transfer of value between preferred shareholders and common shareholders by analogizing to the guidance for stock-based compensation arrangements classified as equity in ASC 718-20-35-3 as the difference between

the fair value of the preferred stock before and after the modification or exchange, measured on the modification or exchange date. Transfers of value should be recorded as a reduction of, or increase to, retained earnings as a deemed dividend. In addition, it should also be recognized as an adjustment to earnings available to common shareholders for purposes of calculating earnings per share. It is important to understand the objective and purpose of the modification when determining the appropriate accounting as other accounting literature may be applicable.

Some modifications of preferred stock may occur in connection with the issuance of new preferred stock. For example, when outstanding preferred stock is modified concurrent with the sale of new preferred stock, the modification may reflect concessions made by existing preferred stockholders regarding their rights in order to attract the new capital. The new preferred stockholders may insist on such concessions as a condition of their investment to avoid immediate dilution of their investment upon closing. An evaluation of fair value of the existing securities before and after the modification may indicate that a transfer of value from the existing preferred stockholders to the new preferred shareholders and the common stockholders has occurred. However, these transactions are often very complex and should be carefully considered to determine the appropriate accounting. Not all of them necessarily constitute transfers of value between the preferred and common shareholder classes, and therefore they may not require recognition as a deemed dividend. For example, while the fair value of the existing preferred stock may be impacted by the changed terms, the value of the entire business may also be impacted by the raising of new capital. In these capital restructurings, it may be reasonable to conclude that the increase in common stock value is incidental to the capital being raised and is not due to a deemed dividend received from the existing preferred shareholders.

## **7.9 Conversion of convertible preferred stock**

In a conversion of convertible preferred stock pursuant to original conversion terms, the preferred stock is exchanged for common shares with no effect on retained earnings. However, the exchange of a number of common shares for preferred stock that differs from the number of common shares exchangeable under the original conversion terms (other than an induced conversion as discussed in FG 7.9.1) is considered an extinguishment.

When a conversion right is exercised, a period of time may elapse between the irrevocable election to convert and the legal exchange of shares. An issuer should reflect the conversion in its financial statements only once the conversion has settled and the rights under the preferred stock have been extinguished. In certain circumstances, there may be additional accounting required between exercise and settlement of the conversion option. For example, if the preferred stock was classified in mezzanine equity prior to the irrevocable election to convert, it may need to be reclassified to permanent equity if the shares in which the preferred stock would convert are not redeemable.

### **7.9.1 Induced conversions**

An induced conversion is a transaction in which an issuer offers additional shares or other consideration (“sweeteners”) to investors to incentivize them to convert their convertible instrument. For example, an issuer may reduce the original conversion price or issue additional consideration (e.g., cash or warrants) not provided for in the original conversion terms to holders that agree to convert during a limited offer period. See FG 6.8.2 after adoption of ASU 2020-06 or FG 6.9.2A before adoption of ASU 2020-06 for additional information on induced conversions.

ASC 260-10-S99-2 addresses the accounting for induced conversions of preferred stock.

**Excerpt from ASC 260-10-S99-2**

If convertible preferred stock is converted into other securities issued by the registrant pursuant to an inducement offer, the SEC staff believes that the excess of (1) the fair value of all securities and other consideration transferred in the transaction by the registrant to the holders of the convertible preferred stock over (2) the fair value of securities issuable pursuant to the original conversion terms should be subtracted from net income to arrive at income available to common stockholders in the calculation of earnings per share. Registrants should consider the guidance provided in Subtopic 470-20 to determine whether the conversion of preferred stock is pursuant to an inducement offer.

In an induced conversion of preferred stock, the fair value of the inducement is charged to retained earnings with an offsetting credit to the inducement consideration as appropriate (e.g., cash, common stock). The fair value of the inducement is also reflected in earnings per share.

The conversion of an instrument into common or preferred stock is not an extinguishment if it only represents the exercise of a conversion right that was included in the original terms of the instrument.

**7.9.2A Conversion of an instrument with a BCF—before adoption of ASU 2020-06**

ASC 470-20-40-1 requires an issuer to recognize any unamortized discount resulting from the separation of a BCF upon conversion of the instrument. For convertible preferred stock, the charge should be recognized as a dividend in retained earnings and earnings per share. Any other unamortized discounts (e.g., created by allocating proceeds to warrants issued with the convertible instrument) should also be recognized as interest expense or as a dividend to retained earnings upon conversion. In accordance with ASC 470-20-40-2, if the amount of BCF discount amortized exceeds the amount the holder realized because conversion occurred at an earlier date, no adjustment should be made to amounts previously amortized. This guidance is unique to convertible instruments containing a BCF and should not be applied to other convertible instruments.

If a convertible instrument with a multiple-step discount is converted at a point in time when the conversion price on that date is less beneficial than the conversion price used to initially record the BCF, any previously recognized amortization of the discount created by separating the BCF should not be reversed. See FG 7.3.2.2A for information on BCFs with a multiple-step discount.

**7.10 Preferred stock extinguishment**

When preferred stock is extinguished, the issuer should include the gain or loss on extinguishment in its net income attributable to common shareholders used to calculate earnings per share, as described in ASC 260-10-S99-2.

**Excerpt from ASC 260-10-S99-2**

If a registrant redeems its preferred stock, the SEC staff believes that the difference between (1) the fair value of the consideration transferred to the holders of the preferred stock and (2) the carrying amount of the preferred stock in the registrant's balance sheet (net of issuance costs) should be subtracted from (or added to) net income to arrive at income available to common stockholders in the calculation of earnings per share. The SEC staff believes that the difference between the fair value of the consideration transferred to the holders of the preferred stock and the carrying amount of the

preferred stock in the registrant's balance sheet represents a return to (from) the preferred stockholder that should be treated in a manner similar to the treatment of dividends paid on preferred stock.

Although there is no guidance specifically on point, we believe direct costs associated with a preferred stock extinguishment (e.g., attorney fees) should be included when calculating the amount of consideration transferred.

If the fair value of the consideration transferred is greater than the carrying amount of the shares surrendered, (1) retained earnings should be reduced by the difference (or additional paid-in capital in the absence of retained earnings), and (2) earnings available to common shareholders should be reduced by the difference.

If the fair value of the consideration transferred is less than the carrying amount of the shares surrendered, the difference should be credited to retained earnings and added to earnings available to common shareholders.

The accounting for an extinguishment of preferred stock classified as a liability under the guidance in ASC 480 is the same as that for other debt instruments. See FG 3.7 for information on accounting for debt extinguishments.

#### **7.10.1A Redemption of convertible preferred stock with a BCF—before adoption of ASU 2020-06**

As discussed in ASC 260-10-S99-2, when a reporting entity redeems convertible preferred stock, it should allocate a portion of the redemption consideration to the reacquisition of the BCF; the remainder of the consideration is allocated to the redemption of the preferred stock. The amount of consideration allocated to reacquisition of the BCF should be equal to the intrinsic value previously recognized (i.e., the original intrinsic value). When the EITF reached this conclusion in its deliberation of EITF Issue 00-27, *Application of Issue No. 98-5 to Certain Convertible Instruments*, it acknowledged that this treatment is inconsistent with the approach applied to the redemption of convertible debt with a BCF. In that circumstance, the redemption consideration is allocated to the BCF based on its extinguishment date intrinsic value.

Example FG 7-5A illustrates how to account for the redemption of preferred stock with a BCF.

#### **EXAMPLE FG 7-6A**

##### **Redemption of preferred stock with a BCF**

FG Corp issues \$1,000 of convertible perpetual preferred stock and 100 detachable warrants to purchase its common stock in exchange for \$1,000 cash. The convertible preferred stock is convertible into 100 shares ( $\$1,000 \text{ convertible preferred stock} / 100 \text{ shares} = \$10 \text{ conversion price}$ ) immediately upon issuance. The warrants have a strike price of \$10 per share.

FG Corp's stock price on the date the instrument is issued, which is the commitment date, is \$10 per share. The fair value of the warrants on that date is \$300.

FG Corp concludes that the warrants should be classified as a liability. Since the warrants are classified as a liability, FG Corp first allocates the proceeds to the warrant based on its fair value (\$300); the remaining proceeds (\$700) are allocated to the convertible preferred stock. However, a BCF exists at

inception as the conversion price (\$7 per share) is less than the fair value of the shares the preferred stock is convertible into (\$10 per share) and must also be recorded. A BCF is recorded in additional paid in capital for \$300 resulting in the preferred stock carry value at issuance being recorded for \$400.

One year after issuance, FG Corp redeems the convertible preferred stock for \$1,200. The convertible preferred stock's carrying amount is now \$700 since the discount created by the BCF was immediately amortized as the preferred stock was convertible immediately.

How should FG Corp account for the redemption of its convertible preferred stock?

### *Analysis*

The redemption of the convertible preferred stock based on allocated reacquisition proceeds of \$900 (\$1,200 cash paid - \$300 original intrinsic value of the conversion feature) would be recorded with the following entry:

|                                 |       |       |
|---------------------------------|-------|-------|
| Dr. Convertible preferred stock | \$700 |       |
| Dr. Retained earnings (loss)    | \$200 |       |
| Cr. Cash                        |       | \$900 |

FG Corp would then record the redemption of the BCF at its original intrinsic value of \$300.

|                                      |       |       |
|--------------------------------------|-------|-------|
| Dr. Additional paid-in capital (BCF) | \$300 |       |
| Cr. Cash                             |       | \$300 |

The \$200 charged to retained earnings upon redemption is in addition to the \$300 charged to retained earnings when the BCF was recognized.

### **7.10.2 Extinguishment of a subsidiary's preferred stock**

The accounting for the redemption of a subsidiary's preferred stock depends on its balance sheet classification, as discussed in ASC 810-10-40-2 and ASC 810-10-40-2A.

#### **Excerpt from ASC 810-10-40-2**

[If] the mandatorily redeemable preferred stock is not accounted for as a liability, then the entity's acquisition of a subsidiary's mandatorily redeemable preferred stock shall be accounted for as a capital stock transaction. Accordingly, the consolidated entity would not recognize in its income statement any gain or loss from the acquisition of the subsidiary's preferred stock.

**Excerpt from ASC 810-10-40-2A**

If mandatorily redeemable preferred stock is accounted for as a liability, then any amounts paid or to be paid to holders of those contracts in excess of the initial measurement amount are reflected as interest cost and not as noncontrolling interest charge. Topic 860 specifies whether a liability has been extinguished and Subtopic 470-50 requires that the parent recognize a gain or loss upon extinguishment of the subsidiary's liability for mandatorily redeemable preferred shares for any difference between the carrying amount and the redemption amount.

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***Chapter 8:***  
***Accounting for certain***  
***contracts to issue shares—***  
***updated December 2021***

## 8.1 Overview of accounting for certain contracts to issue shares

In this chapter we discuss contracts under which a reporting entity sells its own shares for future delivery. These contracts include forward sale contracts, warrants, and variable share forward delivery agreements (components of a mandatory unit structure). This chapter also includes a discussion of the model for allocating proceeds and issuance costs to freestanding instruments issued together, such as debt with detachable warrants. Lastly, this chapter discusses certain instruments issued to shareholders.

See FG 9 for information on contracts to repurchase a reporting entity's own shares.

### ***New guidance—ASU 2020-06***

In August 2020, the FASB issued 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)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the “own stock” scope exception (see FG 5) and certain aspects of the EPS guidance.

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

Guidance in this chapter has been updated to reflect the new ASU and impacted sections are denoted with “after adoption of ASU 2020-06” and “before adoption of ASU 2020-06.”

### ***New guidance—ASU 2021-04***

In May 2021, the FASB issued ASU 2021-04, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40)*. The ASU clarifies the guidance related to an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options (for example, warrants) that remain equity-classified after modification or exchange. The amendments in the ASU are effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. Early adoption is permitted for all entities, including adoption in an interim period. If an entity elects early adoption in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes that interim period. See FG 8.3 for further information.



## 8.2 Contracts to issue shares

For various reasons a reporting entity may choose to sell its own shares for future delivery using a derivative instrument; these contracts can require or permit the reporting entity to issue shares or give the investor the option to buy shares. Figure FG 8-1 summarizes certain common contracts.

### Figure FG 8-1

Summary of certain common contracts to issue shares

| Contract                                  | Summary of terms  | Mandatory or optional settlement |
|---|---|----------------------------------|
| Forward sale                              | Reporting entity agrees to sell a fixed number of shares to an investor on a specified date in the future, typically at a fixed price   | Mandatory                        |
| Warrant (written call option)             | The investor can buy a fixed number of shares on or by a specified date in the future or upon the occurrence of an event, typically at a fixed price                                | Investor's option                |
| Variable share forward delivery agreement | The reporting entity agrees to sell a variable number of shares, based on its stock price or some other variable, to an investor at a fixed price on a specified date in the future | Mandatory                        |

A fixed price contract typically allows for a price adjustment upon the occurrence of specified events.

Settlement may involve “gross physical settlement” where the full number of shares underlying the contract and exercise prices are exchanged or “net settlement” where the unrealized economic gain or loss on the contract is settled by the payment of cash or shares.

#### 8.2.1 Forward sale contracts

A forward sale contract obligates the holder to buy (and obligates the reporting entity to sell) a specified number of the reporting entity's shares at a specified date and price. A forward contract effectively fixes the price a holder will pay for the reporting entity's stock.

Most forward sale contracts are not within the scope of ASC 480, *Distinguishing Liabilities from Equity*; however, the terms of each contract should be evaluated to determine whether that is the case. Certain forward sale contracts are within the scope of ASC 480, including:

- A prepaid forward contract to deliver a variable number of the reporting entity's own shares equal to a fixed monetary amount
- A forward contract to sell redeemable shares

See FG 5.5 for further information on ASC 480.

If a reporting entity concludes that a forward contract is not within the scope of ASC 480, the next step is to determine whether the contract should be classified as a liability or equity under the guidance in ASC 815-40, *Derivatives and Hedging—Contracts in Entity's Own Equity*. See FG 5.6 for further information on the analysis of a freestanding equity-linked instrument under ASC 815 after the adoption of ASU 2020-06 or FG 5.6A for further information on the analysis of a freestanding equity-linked instrument before the adoption of ASU 2020-06.

### **8.2.1.1 Forward sale contracts on redeemable equity**

A reporting entity may enter into a forward sale contract on any class of equity instrument, including preferred shares that are redeemable or contingently redeemable for cash or other assets upon the occurrence of events outside the control of the reporting entity.

A forward sale contract on redeemable shares should be classified as a liability (or, in some cases, an asset, depending on the contract's stock price) based on the guidance in ASC 480 because it creates an obligation for the reporting entity to repurchase its shares. As discussed in ASC 480-10-55-33, this guidance not only applies to mandatorily redeemable and puttable shares, but also to shares that are redeemable, or contingently redeemable upon a defined contingency; the probability of the contingency occurring should not be considered.

See FG 5.5 for information on the application of ASC 480, including initial and subsequent measurement.

### **8.2.2 Warrants (written call options)**

A warrant (or written call option) on a reporting entity's own stock gives the holder the right, but not the obligation, to buy the reporting entity's shares on or by a certain date, at a specified price. The reporting entity receives a premium from the holder when it issues a warrant on its own stock, although oftentimes the premium may be in the form of a lower interest rate on a debt instrument or some other noncash consideration. See FG 8.4.1 for information on accounting for warrants issued with another instrument.

A warrant to sell common or preferred equity is generally outside the scope of ASC 480; however, some warrants, including puttable warrants and warrants on redeemable shares, are within the scope of ASC 480. See FG 8.2.2.1 for information on puttable warrants and FG 8.2.2.2 for information on warrants on redeemable shares.

If a reporting entity concludes that a warrant is not within the scope of ASC 480, the next step is to determine whether the contract should be classified as a liability or equity under the guidance in ASC 815-40. See FG 5.6 for further information on the analysis of a freestanding equity-linked instrument after the adoption of ASU 2020-06 or FG 5.6A for further information on the analysis of a freestanding equity-linked instrument before the adoption of ASU 2020-06.

See FG 8.3 for guidance related to modifications or exchanges of equity-classified warrants (written call options).

### 8.2.2.1 *Puttable warrants*

A puttable warrant is an instrument that allows the holder to either (1) exercise the warrant and receive shares or (2) put the warrant to the reporting entity in exchange for a cash payment. The put feature may be conditional or unconditional.

As discussed in ASC 480-10-55-30, a puttable warrant creates a conditional obligation for the reporting entity to repurchase its shares for cash (or other assets); therefore, it is a liability within the scope of ASC 480. Share-settled put warrants that create an obligation for the reporting entity to issue a variable number of shares may also be within the scope of ASC 480.

#### **ASC 480-10-55-30**

Consider, 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 that the holder could require the issuer to pay in cash. The warrant is not an outstanding share and therefore does not meet the exception for outstanding shares in paragraphs 480-10-25-8 through 25-12. As a result, the example puttable warrant is a liability under those paragraphs, because it embodies an obligation indexed to an obligation to repurchase the issuer's shares and may require a transfer of assets. It is a liability even if the repurchase feature is conditional on a defined contingency in addition to the level of the issuer's share price.

Even if the put right can be only be exercised upon the occurrence of certain events, a puttable warrant should be classified as a liability within the scope of ASC 480. See FG 5.5 for further information on ASC 480.

### 8.2.2.2 *Warrants on redeemable shares*

As discussed in ASC 480-10-55-33, a warrant on redeemable shares (i.e., puttable or mandatorily redeemable shares) is a liability within the scope of ASC 480 because it creates a conditional obligation for the reporting entity to repurchase its shares for cash (or other assets).

#### **ASC 480-10-55-33**

A warrant for puttable shares conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned on the warrant's being exercised and the shares obtained by the warrant being put back to the issuer for cash or other assets. Similarly, a warrant for mandatorily redeemable shares also conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned only on the warrant's being exercised because the shares will be redeemed. Thus, warrants for both puttable and mandatorily redeemable shares are analyzed the same way and are liabilities under paragraphs 480-10-25-8 through 25-12, even though the number of conditions leading up to the possible transfer of assets differs for those warrants. The warrants are liabilities even if the share repurchase feature is conditional on a defined contingency.

The classification of the underlying shares issued upon exercise should not be considered to determine the classification of the warrants. The fact that the shares are puttable (which allows the holder to compel the reporting entity to redeem the shares) is the key fact in determining the warrant's classification as a liability.

See FG 5.5 for further information on ASC 480.

### **8.2.2.3 Penny warrants**

A penny warrant is an instrument that requires the holder to pay little or no consideration to receive the shares upon exercise of the warrant. Since the shares underlying the warrant are issuable for little or no consideration (assuming \$0.01 is non-substantive in relation to the current share price), they should be considered outstanding in the context of basic earnings per share, as discussed in ASC 260-10-45-13. See FSP 7 for information on including penny warrants in earnings per share.

Penny warrants often do not meet the definition of a derivative under ASC 815 because their fair value at issuance is essentially equal to the fair value of the shares underlying the warrant. As such, they have the characteristics of a prepaid forward sale of equity. A reporting entity should evaluate the penny warrants to determine whether the instrument is considered indexed to the entity's own stock (see FG 5.6.2 (after adoption of ASU 2020-06) or FG 5.6.2A (before adoption of ASU 2020-06)) and evaluate whether the instrument meets the requirements for equity classification (see FG 5.6.3 (after adoption of ASU 2020-06) or FG 5.6.3A (before adoption of ASU 2020-06)). If the instrument contains a feature that may preclude the instrument from being considered indexed to the entity's own stock, a reporting entity should also consider whether that feature is substantive in light of the \$0.01 exercise price. If the feature results in an adjustment to the \$0.01 exercise price, it may be considered nonsubstantive and thus would not preclude the instrument from being indexed to the entity's own stock. We believe this is the case because if the \$0.01 exercise price is nonsubstantive, then a fraction of the \$0.01 exercise price must also be nonsubstantive. However, if the feature results in an adjustment to the number of shares underlying the contract, it is a substantive feature which should be analyzed under the guidance and may preclude the instrument from being considered indexed to the entity's own stock. In addition, if the instrument does not meet the requirements for equity classification in ASC 815-40-25 (e.g., if there are not sufficient authorized but unissued shares to satisfy exercise), we believe that it is generally appropriate to account for the instrument as a liability.

Penny warrants may also be issued on redeemable preferred stock or redeemable common stock, which, similar to a penny warrant on non-redeemable common stock, is economically similar to holding the underlying shares (assuming that the \$0.01 exercise price is non-substantive). However, although the penny warrant on redeemable shares is economically similar to owning the underlying shares, the penny warrant is not legally an outstanding share. As such, the penny warrant on redeemable common or redeemable preferred shares may be subject to ASC 480-10-55-33 (see FG 8.2.2.2) and generally should be recorded as a liability.

### **8.2.2.4 Warrants to participate in a future equity offering**

A reporting entity may issue a warrant that allows the holder to purchase shares of the reporting entity's next issuance of preferred stock at the same price paid by other investors in that preferred stock. A warrant to participate in a future equity offering is typically issued to a debt or equity investor. The terms of the future issuance of preferred stock are generally unknown and subject to negotiation with potential investors. Absent a future preferred stock issuance, the warrant holder is not entitled to exercise the warrant for any other consideration.

At issuance, these warrants are generally not a liability within the scope of ASC 480 if it is within the reporting entity's control to decide whether it will sell preferred stock or not. Further, since the terms of any future preferred stock issuance have not been determined, and when determined will generally

be based upon market terms, reporting entities generally do not recognize these contracts until the terms of the underlying shares are determined.

See FG 7.6 for information on tranches of preferred stock.

#### **8.2.2.5A BCFs in warrants to acquire convertible shares—before adoption of ASU 2020-06**

The following guidance related to BCFs in warrants to acquire convertible shares will no longer be applicable upon a reporting entity's adoption of ASU 2020-06 as the beneficial conversion feature model has been eliminated.

A beneficial conversion feature (BCF) is an embedded conversion option that is in the money at the commitment date. FG 7.3.2.2A provides a detailed discussion on BCFs; this section only discusses the accounting for BCFs in warrants to acquire convertible shares. See FG 7.3.2.2A for further information on the accounting for BCFs.

Whether a BCF in a warrant to acquire convertible shares should be recognized when the warrant is issued or when the warrant is exercised (and the convertible shares are issued), depends on the classification of the warrant itself.

The Emerging Issues Task Force considered whether a warrant to acquire convertible shares may have a BCF during its deliberations of EITF No. 00-27, *Application of Issue No. 98-5 to Certain Convertible Instruments*. Although this guidance was not finalized, we believe the EITF's tentative conclusions may be applied in the absence of other guidance. The EITF tentatively concluded that, for warrants classified as a liability, a reporting entity should not assess whether there is a BCF until the warrant is exercised and the convertible shares are issued, provided the warrant can only be physically settled in shares. To determine the intrinsic value upon exercise, the EITF concluded that a reporting entity should compare the fair value of the reporting entity's common stock (or other shares into which the security is convertible) on the exercise date with the effective conversion price. The effective conversion price should be calculated as the sum of the carrying amount of the warrant liability plus the exercise price of the warrant divided by the number of common shares the warrant holder receives if the conversion feature embedded in the convertible share is exercised.

Example FG 8-1A illustrates the application of this guidance to the recognition of a BCF in warrants classified as liabilities to purchase convertible preferred stock.

#### **EXAMPLE FG 8-1A**

##### **Recognition of a BCF in warrants classified as liabilities**

FG Corp issues 100 warrants that allow each holder to buy convertible preferred shares. The exercise price is \$10 per warrant. Each convertible preferred share is convertible into 5 shares of FG Corp common stock, or 500 shares in total.

FG Corp determines that the warrants should be classified as a liability with a fair value of \$1,000.

Two years after the warrants are issued, the warrant holder exercises the warrants and receives 100 shares of FG Corp convertible preferred stock. On that date, the fair value of FG Corp common stock is \$25 and the carrying value (fair value) of the warrants is \$13,000.

When and how should FG Corp determine whether there is a BCF in the warrants that holders can exercise to buy its convertible preferred stock?

### *Analysis*

Since the warrants are classified as a liability, FG Corp assesses whether there is a BCF to be recognized when the warrant is exercised, not when the warrant is issued.

Upon exercise of the warrants, FG Corp compares (1) the fair value of the common shares on the exercise date (\$25) with (2) the effective conversion price of \$28 and determines there is no BCF. The effective conversion price is calculated as follows:

$(\$13,000 \text{ carrying amount of the warrant liability plus } \$1,000 \text{ exercise price of the warrant}) \div 500 \text{ shares (the number of common shares received upon conversion of the convertible shares)}$ .

The effective conversion price on the date warrants are exercised is typically greater than the fair value of the common shares. Therefore, there is generally no BCF.

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The EITF tentatively reached a different conclusion for warrants classified as equity that will be physically settled in shares. For those warrants, the EITF concluded that a reporting entity should assess whether there is a BCF on the date warrants are issued. This conclusion assumes the reporting entity receives fair value for the warrants (or for the warrants and any other instruments issued at the same time) upon issuance. If the reporting entity receives less than the fair value of the warrants, it should assess whether there is a BCF when the warrants are exercised and the convertible shares are received, similar to liability-classified warrants.

To determine the intrinsic value of an equity-classified warrant, the EITF concluded that a reporting entity should compare the fair value of the reporting entity's common stock (or other shares into which the security is convertible) on the date the warrant is issued with the effective conversion price. The effective conversion price should be calculated as the sum of the proceeds received for (or amount allocated to) the warrant plus the exercise price of the warrant divided by the number of common shares the warrant holder receives if the conversion feature embedded in the convertible share is exercised.

If a reporting entity determines that a BCF should be recognized, it should be recorded as a deemed distribution to the warrant holder. The amount of the BCF cannot exceed the proceeds allocated to the warrant, and should be amortized over the life of the warrants. Upon exercise of the warrants, the unamortized BCF amount should be amortized from the exercise date of the warrant through the stated maturity date of the underlying convertible instrument. If the underlying convertible instrument does not have a stated maturity date, the remaining BCF should be amortized from the exercise date through the date the shares are first convertible.

## 8.3 *Modifications or exchanges of equity-classified written call options*

### *New guidance*

In May 2021, the FASB issued ASU 2021-04, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40)*. The ASU clarifies the guidance related to an issuer’s accounting for modifications or exchanges of freestanding equity-classified written call options (for example, warrants) that remain equity-classified after modification or exchange. The amendments in the ASU are effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. Early adoption is permitted for all entities, including adoption in an interim period. If an entity elects early adoption in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes that interim period.

Under this guidance, a reporting entity should recognize the effect of a modification or an exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange on the basis of the substance of the transaction in the same manner as if cash had been paid as consideration.

Modifications or exchanges that are not related to debt or equity financings, compensation for goods or services, or other exchange transactions within the scope of other guidance should be recognized as a dividend consistent with ASC 815-40-35-17(d). The dividend amount is measured as the excess, if any, of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before it is modified or exchanged in accordance with ASC 815-40-35-16. See FSP 7.4.1.6 for additional information related to the computation of earnings per share.

ASC 815-40-35-3 refers to ASC 815-40-35-14 through ASC 815-40-35-18 for guidance on an issuer’s accounting for modifications or exchanges of freestanding equity-classified written call options that remain equity classified after modification or exchange.

### **Issuer’s Accounting for Modifications or Exchanges of Freestanding Equity-Classified Written Call Options**

#### **ASC 815-40-35-14**

The guidance in paragraphs 815-40-35-15 through 35-18 applies to an issuer’s accounting for a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option (for example, a warrant) that remains equity classified in accordance with this Subtopic after the modification or exchange and is not within the scope of another Topic. An entity shall account for the effects of a modification or an exchange in accordance with paragraphs 815-40-35-15 through 35-18. The disclosure requirements in paragraphs 815-40-50-5 through 50-6 and 505-10-50-3 shall apply to a modification or an exchange of a freestanding equity-classified written call option. The guidance in paragraphs 815-40-35-16 through 35-17 does not apply to freestanding equity-classified written call options that are modified or exchanged to compensate grantees in a **share-based payment arrangement**. An entity shall recognize the effect of such modifications of freestanding equity-

classified written call options by applying the requirements in Topic 718: however, classification of the instrument will remain subject to the requirements in this Subtopic.

#### **ASC 815-40-35-15**

An entity shall consider the circumstances of the modification or exchange of a freestanding equity-classified written call option to determine whether the modification or exchange is related to a financing or other arrangement or a multiple-element arrangement (for example, an arrangement involving both debt financing and equity financing). In making that determination, an entity shall consider all of the terms and conditions of the modification or exchange, other **transactions** entered into contemporaneously or in contemplation of the modification or exchange, other rights and privileges obtained or obligations incurred (including services) as a result of the modification or exchange, and the overall economic effects of the modification or exchange. If the modification or exchange is not within the scope of another Topic, an entity shall apply the guidance in paragraphs 815-40-35-16 through 35-18.

#### **ASC 815-40-35-16**

An entity shall treat a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option as an exchange of the original instrument for a new instrument. In substance, the entity repurchases the original instrument by issuing a new instrument. For transactions recognized in accordance with paragraph 815-40-35-17(c), the effect of a modification or an exchange shall be measured as the difference between the **fair value** of the modified or exchanged instrument and the fair value of that instrument immediately before it is modified or exchanged. For all other transactions recognized in accordance with paragraph 815-40-35-17, the effect of a modification or an exchange shall be measured as the excess, if any, of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before it is modified or exchanged. In a multiple-element transaction, the total effect of the modification or exchange shall be allocated to the respective elements in the transaction.

#### **ASC 815-40-35-17**

An entity shall recognize the effect of a modification or an exchange (calculated in accordance with paragraph 815-40-35-16) in the same manner as if cash had been paid as consideration, as follows:

- a. **Equity issuance.** An entity shall recognize the effect of a modification or an exchange that is directly attributable to a proposed or actual equity offering as an equity issuance cost. For additional guidance see SAB Topic 5.A, Expenses of Offering (paragraph 340-10-S99-1).
- b. **Debt origination.** An entity shall recognize the effect of a modification or an exchange that is a part of or directly related to an issuance of a debt instrument as a debt discount or debt issuance cost in accordance with the guidance in Topic 835 on interest.
- c. **Debt modification.** An entity shall recognize the effect of a modification or an exchange that is a part of or directly related to a modification or an exchange of an existing debt instrument in accordance with the guidance in Subtopic 470-50 on debt modifications and extinguishments and Subtopic 470-60 on troubled debt restructurings by debtors.



d. Other. An entity shall recognize the effect of a modification or an exchange that is not related to a financing transaction in (a) through (c) and is not within the scope of any other Topics (such as Topic 718) as a dividend. Additionally, for an entity that presents earnings per share (EPS) in accordance with Topic 260, that effect shall be treated as a reduction of income available to common stockholders in basic earnings per share in accordance with the guidance in paragraph 260-10-45-15.

#### **ASC 815-40-35-18**

Example 22 (see paragraphs 815-40-55-49 through 55-52) illustrates the application of the guidance in paragraphs 815-40-35-14 through 35-17.

In a multiple-element transaction (e.g., one that includes both debt and equity financings), the total effect of the modification should be allocated to the respective elements in the transaction.

## **8.4 Accounting for freestanding instruments issued together**

A reporting entity may issue multiple freestanding instruments in a bundled transaction. Typically, a debt or preferred equity instrument is issued with a share issuance contract, such as a warrant or variable share delivery agreement. A reporting entity may issue freestanding instruments together to meet its financing objectives, meet its investors' objectives, or for tax purposes.

If a reporting entity issues a non-detachable equity derivative that is not deemed to be a freestanding instrument (see FG 5.3), such as a warrant, with a debt or preferred stock instrument (e.g., the debt or equity security must be surrendered or repaid in order to exercise the warrant), the combined instrument is substantially equivalent to convertible debt or convertible preferred stock. In that case, the reporting entity should account for the combined instrument using the guidance for convertible debt or convertible preferred stock. See FG 6 for information on accounting for convertible debt after the adoption of ASU 2020-06, FG 6A for information on accounting for convertible debt before the adoption of ASU 2020-06, and FG 7 for information on the accounting for convertible preferred stock.

When multiple investors invest in multiple classes of instruments (e.g., preferred stock, common stock, and warrant) in different quantities, the allocation of proceeds to each instrument should be performed at the investor level, not the class level. See FG 8.4.1 for information on allocating proceeds to each instrument.

### **8.4.1 Warrants issued in connection with debt or equity**

Detachable warrants (or warrants that are deemed to be freestanding instruments (see FG 5.3)) issued in a bundled transaction with debt and equity offerings are accounted for separately. The allocation of the sales proceeds between the base instrument (i.e., the debt or equity instrument) and the warrants depends on whether the warrants should be accounted for as equity or a liability. See FG 5.2 for information on the analysis of equity-linked instruments.

If the warrants are classified as equity, then the proceeds should be allocated based on the relative fair values of the base instrument and the warrants following the guidance in ASC 470, *Debt*.

**ASC 470-20-25-2**

Proceeds from the sale of a debt instrument with stock purchase warrants (detachable call options) shall be allocated to the two elements based on the relative fair values of the debt instrument without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants shall be accounted for as paid-in capital. The remainder of the proceeds shall be allocated to the debt instrument portion of the transaction. This usually results in a discount (or, occasionally, a reduced premium), which shall be accounted for under Topic 835 [*Interest*].

Although this guidance is for debt instruments issued with warrants, preferred shares issued with equity-classified warrants should be accounted for in a similar manner.

If the warrants are classified as a liability and recorded at fair value with changes in fair value recorded in the income statement, then the proceeds should be allocated first to the warrants based on their fair value (not relative fair value). The residual should be allocated to the remaining debt and/or equity instruments. This approach avoids the possibility of recording a day one gain or loss on the warrant which could arise if the allocation were made on a relative fair value basis.

The allocation of proceeds to the warrant, using either method, will typically create a discount in the associated debt or equity instrument, which should be recognized as interest expense or a dividend in some cases.

In rare cases, the fair value of the liability-classified warrants may exceed the proceeds received in the bundled transaction. The guidance described in FG 5.4.5 related to the issuance of a hybrid instrument when the fair value of the embedded derivative liability required to be measured at fair value (e.g., bifurcated derivative) exceeds the net proceeds received should be applied by analogy to the bundled transaction. As a result, if the fair values are appropriate, the transaction was conducted on an arm's length basis, and there are no rights or privileges that require separate accounting recognition, the difference between the fair value of the liability-classified warrants and the net proceeds received is recognized as a day-one loss in earnings. See FG 5.4.5 for additional considerations related to the application of the guidance.

Example FG 8-2 illustrates the model for allocating proceeds when equity classified warrants are issued in connection with a debt instrument. Example FG 8-3 illustrates the model for allocating proceeds when liability classified warrants are issued in connection with a debt instrument.

**EXAMPLE FG 8-2****Warrants classified as equity issued in connection with a debt instrument**

FG Corp issues \$1,000 of debt and 100 detachable warrants to purchase its common stock, in exchange for \$1,000 in cash. FG Corp concludes that the warrants meet the requirements for equity classification.

Since the warrants are classified as equity, FG Corp allocates the proceeds from the issuance of the debt instrument and warrants based on their relative fair values.

The fair values and amounts allocated to the debt instrument and warrants are shown in the following table.

| Instrument | Fair value | Percent of total fair | Allocated amount |
|------------|------------|-----------------------|------------------|
| Debt       | \$910      | 70%                   | \$700            |
| Warrants   | \$390      | 30%                   | \$300            |
| Total      | \$1,300    | 100%                  | \$1,000          |

How should FG Corp record the issuance of the debt instrument and warrants?

*Analysis*

FG Corp should record the following journal entry.

|   |  |         |         |
|---|--|---------|---------|
| Dr. Cash                                |  | \$1,000 |         |
| Dr. Discount on debt instrument         |  | \$300   |         |
| Cr. Debt instrument                     |  |         | \$1,000 |
| Cr. Additional paid-in capital—warrants |  |         | \$300   |

### EXAMPLE FG 8-3

#### Warrants classified as liabilities issued in connection with a debt instrument

FG Corp issues \$1,000 of debt and 100 detachable warrants to purchase its common stock, in exchange for \$1,000 in cash. FG Corp concludes that the warrants have a fair value of \$390 and meet the requirements for liability classification.

How should FG Corp record the issuance of the debt instrument and warrants?

*Analysis*

Since the warrants are classified as a liability, FG Corp allocates the proceeds from the issuance of the debt instrument first to the warrants based on their fair value. The residual amount is allocated to the debt instrument.

FG Corp should record the following journal entry.

|                                 |  |         |         |
|---------------------------------|--|---------|---------|
| Dr. Cash                        |  | \$1,000 |         |
| Dr. Discount on debt instrument |  | \$390   |         |
| Cr. Debt                        |  |         | \$1,000 |
| Cr. Warrant liability           |  |         | \$390   |

**8.4.1.1 Issuance costs for non-revolving debt with warrants—after adoption of ASU 2020-06**

The allocation of issuance costs should mirror the accounting for the warrant itself. Issuance costs not specifically related to an instrument issued should be allocated in the same proportion as the proceeds are allocated to the debt (or preferred) and warrants. Issuance costs allocated to a warrant liability should be expensed as incurred and certain issuance costs allocated to an equity-classified warrant should be recorded in equity.

Issuance costs that relate specifically to the issuance of the debt (or preferred) or the warrant, rather than the transaction as a whole, should be allocated to that instrument.

See FG 1.2.2 for further information on which costs qualify as issuance costs.

**8.4.1.1A Issuance costs for non-revolving debt with warrants—before adoption of ASU 2020-06**

The allocation of issuance costs should mirror the accounting for the warrant itself. Issuance costs not specifically related to an instrument issued should be allocated in the same proportion as the proceeds are allocated to the debt (or preferred) and warrants. Issuance costs allocated to a warrant liability should be expensed as incurred and certain issuance costs allocated to an equity-classified warrant should be recorded in equity.

Issuance costs that relate specifically to the issuance of the debt (or preferred) or the warrant, rather than the transaction as a whole, should be allocated to that instrument.

This discussion does not apply to convertible debt within the cash conversion sections of ASC 470-20. These subsections apply to convertible debt instruments that allow, or require, the reporting entity to settle its obligation upon conversion, in whole or in part, in a combination of cash and stock. See FG 6.6A for information on ASC 470-20.

See FG 1.2.2 for further information on which costs qualify as issuance costs.

**8.4.1.2 Detachable warrants issued to obtain a line of credit**

The guidance in ASC 470-20-25-2 does not apply when warrants are issued to obtain a line of credit rather than in connection with the issuance of a debt instrument. Warrants issued to obtain a line of credit should be recorded at fair value when the line of credit agreement is signed; this is the accounting regardless of whether the warrants are classified as a liability or equity. Issuing warrants to obtain a line of credit is equivalent to paying a loan commitment or access fee (equivalent to the fair value of the warrant). As such, these costs meet the definition of an asset and should be recorded as such on the balance sheet and amortized on a straight-line basis over the stated term of the line of credit (i.e., the access period). This accounting applies even if the line is fully drawn down at inception, since the warrants are issued in exchange for access to capital.

See FG 5.2 for information on the analysis of equity-linked instruments including warrants.

**8.4.1.3 Repurchase of debt with detachable warrants**

When a reporting entity extinguishes debt with detachable warrants that are classified as equity, it should allocate the repurchase price to the debt instrument and the warrants using a relative fair value allocation.

The repurchase price amount allocated to the debt instrument should be used to calculate any gain or loss on debt extinguishment. See FG 3.7 for information on debt extinguishment accounting.

The repurchase price amount allocated to the warrants is recorded as a reduction of additional paid-in capital. There is no gain or loss recognized in the income statement when a common equity instrument is retired provided the reporting entity does not convey additional rights and privileges.

### 8.4.2 **Mandatory units**

Mandatory units are equity-linked financial products often marketed under different proprietary names by different financial institutions (e.g., ACES, PRIDES, or DECS). Typically, from the reporting entity's perspective, a mandatory unit consists of (a) a term debt instrument with a remarketing feature and (b) a "variable share forward delivery agreement," i.e., a detachable forward sale contract that obligates the investor to purchase shares of the reporting entity's common stock at a specified time and at a specified price before the maturity of the debt instrument. The number of shares to be received by the holder is based on the market price of the reporting entity's stock on the settlement date of the contract.

Typically, the terms of the debt instrument issued as part of a mandatory unit structure include:

- A stated principal amount equal to the settlement price of the variable share forward delivery agreement. The debt instrument is initially pledged to secure the investor's obligation to pay the settlement price of the variable share forward delivery agreement.
- A fixed maturity with a "remarketing" of the instrument prior to the exercise date of the variable share forward delivery agreement
- The interest rate is a fixed rate for the period from issuance to the remarketing date
- At the remarketing date, the debt instrument is sold to new investors at par with a new interest rate equal to the then market rate for debt with the remaining term to maturity. The debt instrument must be sold for an amount at least equal to par, which is equal to the settlement price of the variable share forward delivery agreement. If the remarketing does not result in a successful sale at the minimum required price (i.e., a failed remarketing), then the debt instrument is typically delivered to the reporting entity to pay the settlement price of the variable share forward delivery agreement. Generally, the interest rate a reporting entity will pay upon remarketing is not limited, making a failed remarketing less likely to occur.

The number of shares issued under the variable share forward delivery agreement will depend on the price of the underlying stock at the end of the contract. For example, an agreement may be structured as follows, assuming an investor pays \$50 to settle the variable share forward delivery agreement:

| <b>If the stock price is:</b> | <b>The reporting entity issues:</b>                                    |
|-------------------------------|--|
| Less than \$50                | 1 share  |
| Between \$50 and \$62.50      | A pro rata portion of a share, between 1 and 0.8 shares, equal to \$50 |
| Greater than \$62.50          | 0.8 shares   |

In this example, the variable share forward delivery agreement comprises three features from the issuer's perspective:

- A purchased put on the issuer's own shares (a put on one share with an exercise price of \$50)
- A written call option on the issuer's own shares (a call on 0.8 shares with an exercise price of \$62.50)
- An agreement to issue the issuer's own shares at their prevailing fair values (if the share price is between \$50 and \$62.50)

Because the variable share forward delivery agreement is legally detachable from the debt instrument, it is typically considered a freestanding instrument and accounted for separately. See FG 5.3 for further information on determining whether an instrument is freestanding or embedded.

ASC 480-10-55-50 provides guidance for analyzing a variable share forward delivery contract.

#### **ASC 480-10-55-50**

Entity D enters into a contract to issue shares of Entity D's stock to Counterparty in exchange for \$50 on a specified date. If Entity D's share price is equal to or less than \$50 on the settlement date, Entity D will issue 1 share to Counterparty. If the share price is greater than \$50 but equal to or less than \$60, Entity D will issue \$50 worth of fractional shares to Counterparty. Finally, if the share price is greater than \$60, Entity D will issue .833 shares. At inception, the share price is \$49. Entity D has an obligation to issue a number of shares that can vary; therefore, paragraph 480-10-25-14 may apply. However, unless it is determined that the monetary value of the obligation to issue a variable number of shares is predominantly based on a fixed monetary amount known at inception (as it is in the \$50 to \$60 share price range), the financial instrument is not in the scope of this Subtopic.

See FG 5.5.1 for further information on the scope of ASC 480, including information on "predominantly." If a reporting entity concludes that a variable share forward delivery agreement is not within the scope of ASC 480, the next step to determine the accounting treatment is to determine whether it should be classified as a liability or equity under the guidance in ASC 815-40. See FG 5.6 for further information on the analysis of a freestanding equity-linked instrument after adoption of ASU 2020-06 or FG 5.6A for further information on the analysis of a freestanding equity-linked instrument before the adoption of ASU 2020-06.

#### **8.4.2.1 Contract payments paid by the reporting entity**

Typically, the investor in a mandatory unit structure receives quarterly payments comprising both (a) interest on the debt instrument and (b) "contract payments" on the variable share forward delivery agreement. The contract payments result from the fact that the purchased put in the variable share forward delivery agreement has a greater value than the written call, resulting in a net premium which must be paid for the net purchased put on the reporting entity's own stock. Rather than paying the premium up front, the issuer pays the premium over time in the form of contract payments.

If the variable share forward delivery agreement is accounted for as an equity instrument, the reporting entity should account for the obligation to make the contract payments as a liability measured at the present value of the payments over the life with an offsetting entry to additional paid-

in capital. The liability is subsequently accreted using the effective interest method over the life of the variable share forward delivery agreement, with an offsetting entry to interest expense.

### 8.4.2.2 Application example

Example FG 8-4 illustrates the accounting for mandatory units.

#### EXAMPLE FG 8-4

##### Accounting for mandatory units

FG Corp issues 10 mandatory units to investors. Each mandatory unit has a stated par value of \$1,000 and consists of:

- A five-year debt security of FG Corp with principal amount of \$1,000 and an initial rate of 4%, paid quarterly, for the first thirty-three months. At the end of 33 months, the debt security will be remarketed and the interest rate will reset to the market rate for the remaining life of the debt security.
- A three-year variable share forward delivery agreement with a 1% contract payment. At maturity, each investor will pay FG Corp \$1,000 per unit and get a variable number of shares depending on FG Corp's stock price at the maturity date, as summarized below.

| If the stock price is:   | FG Corp issues:                              |
|--------------------------|--|
| Less than \$50           | 20 shares                                    |
| Between \$50 and \$62.50 | A pro rata number of shares equal to \$1,000 |
| Greater than \$62.50     | 16 shares                                    |

FG Corp's common stock has a \$1.00 par value.

FG Corp determines that the debt security and the variable share forward delivery agreement are freestanding instruments and should be accounted for separately because they are legally detachable and separately exercisable. In addition, FG Corp performs an analysis of the variable share forward delivery agreement and concludes that (1) it is not within the scope of ASC 480 and (2) it is indexed to its own stock and meets the additional requirements for equity classification in ASC 815-40 and, therefore, should be accounted for as an equity instrument. As a result, the proceeds are allocated to the debt security and the variable share forward delivery contract based on their relative fair values. The obligation associated with the variable share forward delivery agreement has a fair value of \$275; the fair value is imputed based upon the present value of the contract payments discounted at FG Corp's three-year financing rate.

Upon remarketing, the interest rate on the debt resets to FG's then current borrowing rate of 3.8%. At settlement of the variable share forward delivery agreement, FG Corp's stock price is \$65.00.

How should FG Corp record (1) the issuance of the mandatory units, (2) the periodic entries over the life of the instruments, (3) the remarketing of the debt security, (4) the maturity of the variable share forward delivery agreement, and (5) the maturity of the debt?

*Analysis**Issuance of the mandatory units*

FG Corp records the issuance of its mandatory units by recording the cash proceeds, the debt security, and the present value of the contract payments related to the variable share forward delivery agreement.

|                                |           |          |
|--------------------------------|-----------|----------|
| Dr. Cash                       | \$ 10,000 |          |
| Dr. Equity – APIC              | \$275     |          |
| Cr. Debt security              |           | \$10,000 |
| Cr. Contract payment liability |           | \$275    |

*Periodic entries over the life of the instrument*

FG Corp calculates the quarterly interest expense as follows:

$$\$10,000 \times 4\% \times \frac{1}{4} = \$100$$

FG Corp records interest payments made to investors.

|                            |       |       |
|----------------------------|-------|-------|
| Dr.<br>Interest<br>expense | \$100 |       |
| Cr.<br>Cash                |       | \$100 |

FG Corp calculates the quarterly contract payment as follows:

$$\$10,000 \times 1\% \times \frac{1}{4} = \$25$$

FG Corp records the cash paid for the contract payment obligation; the offsetting entry is recorded to reduce the contract payment liability and recognize interest expense using the interest method on the contract payment liability.

|                                |      |      |
|--------------------------------|------|------|
| Dr. Contract payment liability | \$21 |      |
| Dr. Interest expense           | \$4  |      |
| Cr. Cash                       |      | \$25 |

*Upon remarketing of the debt security*

Once the debt security is remarketed, FG Corp records quarterly interest expense of \$95 ( $\$10,000 \times 3.8\% \times \frac{1}{4} = \$95$ ) over the remaining life.

|                      |      |      |
|----------------------|------|------|
| Dr. Interest expense | \$95 |      |
| Cr. Cash             |      | \$95 |



The actual remarketing is not recognized by FG Corp as an extinguishment and reissuance because it is a transaction among third party market participants.

*Upon maturity of the variable share forward delivery agreement*

FG Corp records the proceeds received upon settlement of the variable share forward delivery agreement and the issuance of shares at par value (10 units × 16 shares per unit × \$1.00 par value = \$160) with the remainder recorded to APIC.

|                                     |          |         |
|-------------------------------------|----------|---------|
| Dr. Cash                            | \$10,000 |         |
| Cr. Equity – par value common stock |          | \$160   |
| Cr. Equity – APIC                   |          | \$9,840 |

*Upon maturity of the debt security*

FG Corp records the cash paid upon redemption of the debt security.

|          |          |          |
|----------|----------|----------|
| Dr. Debt | \$10,000 |          |
| Cr. Cash |          | \$10,000 |

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#### **8.4.2.3 Issuance costs**

In many cases, the variable share delivery agreement is accounted for as an equity instrument and the issuance costs should be allocated to the debt instruments and the variable share delivery agreement in a rational manner. One acceptable method is to allocate issuances costs to the debt and equity instruments based on their relative fair values on an absolute value basis.

See FG 1.2.2 for further information on which costs qualify as issuance costs.

#### **8.4.2.4 Earnings per share**

The diluted earnings per share (EPS) treatment of a unit structure with an equity classified variable share delivery agreement depends on whether (1) the debt instrument can be tendered to satisfy the investor's payment of the exercise price for the variable share forward delivery agreement and (2) whether the debt instrument and variable share forward delivery agreement mature on, or close to, the same date.

ASC 260-10-55-9 provides guidance on the computation of diluted EPS for instruments that require or permit the tendering of a debt instrument in satisfaction of the exercise price.

#### **ASC 260-10-55-9**

Options or warrants may permit or require the tendering of debt or other securities of the issuer (or its parent or its subsidiary) in payment of all or a portion of the exercise price. In computing diluted EPS, those options or warrants shall be assumed to be exercised and the debt or other securities shall be assumed to be tendered. If tendering cash would be more advantageous to the option holder or warrant holder and the contract permits tendering cash, the treasury stock method shall be applied.

Interest (net of tax) on any debt assumed to be tendered shall be added back as an adjustment to the numerator. The numerator also shall be adjusted for any nondiscretionary adjustments based on income (net of tax). The treasury stock method shall be applied for proceeds assumed to be received in cash.

This method results in EPS dilution similar to the use of the if-converted method. See FSP 7.5.6 (after adoption of ASU 2020-06) or FSP 7.5.6A (before adoption of ASU 2020-06) for information on the if-converted method. This same treatment should be applied if the debt instrument and variable share forward delivery agreement mature on, or close to, the same date.

If the debt instrument cannot be tendered to satisfy the investor's payment of the exercise price for the share issuance derivative, the instrument is included in diluted EPS as follows:

- The coupon on the debt instrument is included as interest expense and therefore results in a reduction of earnings available to common shareholders
- The variable share forward delivery agreement is included as a potentially issuable common share using the treasury stock method; see FSP 7.5.5 for information on applying the treasury stock method

Typically, the base security in the unit offering will be remarketed at some point prior, but close to, the maturity of the variable share forward delivery agreement. For example, the debt instrument may have a five year life, with a remarketing after 2.75 years, and the variable share forward delivery agreement will mature at the end of 3 years. With at least 90 days difference between the debt instrument's remarketing date and the maturity of the variable share forward delivery agreement, the two instruments are not considered coterminous so the treasury stock method should be applied. However, most securities also allow the investor to use the debt instrument to satisfy the exercise price of the share issuance derivative in the event of a failed remarketing. If this occurs, the two instruments do co-terminate and the approach similar to the if-converted method should be applied.

In determining the method for including a unit structure in diluted EPS, a reporting entity should consider the likelihood that the debt instrument will be used to satisfy the exercise price of the variable share forward delivery agreement (i.e., they will co-terminate). If the instruments are coterminous only upon a failed remarketing, then provided the likelihood of a failed remarketing is considered remote, use of the treasury stock method is generally appropriate.

If the likelihood of a failed remarketing became reasonably possible (i.e., more than remote likelihood), the reporting entity would need to begin to use the "if-converted method" in computing earnings per share. Some reporting entities may wish to build flexibility into the remarketing provisions permitting changes to the terms of the debt instrument. While this may increase the likelihood of a successful remarketing, we believe that providing too much flexibility in modifications that can be made in conjunction with the remarketing of the debt would place stress on the reporting entity's ability to use the treasury stock method of computing diluted EPS. This is because providing too much flexibility in the arrangement may suggest that when utilized, a substantive modification of the debt has occurred that would need to be accounted for as an extinguishment of the old debt and issuance of a new debt instrument.

### 8.4.2.5 Repurchase of mandatory units

When a reporting entity extinguishes mandatory units that include an equity classified variable share forward, such as through an open market repurchase of the instruments, the accounting treatment depends on whether the variable share forward delivery agreement is economically an asset or liability to the issuer. For example, using the terms in Example FG 8-4:

- If the issuer's stock price were \$40, it would be required to deliver 20 shares of its stock with a fair value of \$800 in exchange for \$1,000 in cash; therefore the variable share forward delivery agreement is economically in a gain position to the issuer.
- If the issuer's stock price were \$75, it would be required to deliver 16 shares of its stock with a fair value of \$1,200 in exchange for \$1,000 in cash, therefore the variable share forward delivery agreement is economically in a loss position to the issuer.

The contract payment liability discussed in FG 8.4.2.1 is an additional liability that should be included in the debt extinguishment analysis discussed below.

If the variable share forward delivery agreement is economically a liability to the issuer, the repurchase price (cash and fair value of the common stock) should be allocated to the debt instruments (i.e., the debt instrument and contract payment liability) and variable share forward delivery agreement using a relative fair value methodology.

- A gain or loss on extinguishment equal to the difference between (1) the amount allocated to the debt instruments and (2) the carrying value is recognized in earnings; see FG 3.7 for further discussion of debt extinguishment accounting
- The portion of the repurchase price attributable to the equity-classified variable share forward delivery agreement is recorded as a reduction of additional paid-in capital. There is no loss recognized when a common equity instrument is retired provided the issuer does not convey additional rights and privileges that require recognition of income or expense

If, however, the variable share forward delivery agreement is economically an asset to the issuer, we believe the fact that the forward is being used as consideration to extinguish the obligation should be considered. One method of doing this is to record:

- A gain or loss on extinguishment equal to the difference between (1) the consideration paid *plus* the fair value of the equity-classified variable share forward delivery agreement and (2) the carrying value of the debt instrument; see FG 3.7 for further discussion of debt extinguishment accounting
- The portion of the repurchase price attributable to the equity-classified variable share forward delivery agreement (i.e., its fair value used in calculating the gain or loss on extinguishment) is recorded as an increase in additional paid-in capital

There may be other acceptable methods of performing this calculation.

## **8.5 Shareholder rights plan (“poison pill” takeover defenses)**

To discourage unfriendly takeover attempts, a reporting entity may grant its existing shareholders rights which convert to the reporting entity’s common stock upon the occurrence of specified events, such as the accumulation of a significant percentage of the reporting entity’s outstanding shares by a single shareholder. These rights are often referred to as “poison pill” takeover defenses. The issuance of rights to existing shareholders on a pro rata basis is typically accounted for as a dividend with the offsetting entry recorded to APIC, if the rights meet the requirements for equity classification, or as a liability, if they do not meet the requirements for equity classification. See FG 5.2 for information on the analysis of equity-linked instruments.

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***Chapter 9:  
Share repurchase and  
treasury stock—updated  
December 2021***

## 9.1 Overview of share repurchase and treasury stock

When a reporting entity repurchases its common shares, it is distributing cash to existing shareholders to reacquire a portion of its outstanding equity. Once a reporting entity has acquired its own shares it may choose to retire the reacquired shares or hold them as treasury stock.

This chapter discusses the accounting for several share repurchase alternatives. It also discusses the accounting for treasury stock and share retirements.

See FSP 5.9 for information on the presentation and disclosure requirements of treasury stock.

### *New guidance*

In August 2020, the FASB issued 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)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the “own stock” scope exception (see FG 5) and certain aspects of the EPS guidance (see FSP 7).

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period other than the first interim period of its fiscal year.

Guidance in this chapter has been updated to reflect the new ASU and impacted sections are denoted with “after adoption of ASU 2020-06” and “before adoption of ASU 2020-06.”

## 9.2 Share repurchases

A reporting entity may repurchase its common shares for a number of reasons, including to:

- Return cash to shareholders
- Increase earnings per share or other financial metrics (e.g., return on equity) that may be of interest to shareholders
- Send a signal to the market that management believes its common stock price is undervalued
- Offset the issuance of shares (e.g., from employee stock option exercise)
- Preclude potentially hostile acquirers from gaining control of, or significant influence over, the reporting entity
- Buyout a partner or major stockholder's ownership position

Figure FG 9-1 summarizes some of the more common methods reporting entities use to repurchase its common shares.

**Figure FG 9-1**  
Types of share repurchase arrangements

| <b>Repurchase type</b>                           | <b>Overview</b>   |
|--|---|
| Forward repurchase contract<br>(FG 9.2.2)        | Reporting entity agrees to purchase shares for a specified price on a specified date in the future  |
| Spot repurchase<br>(FG 9.2.3)                    | Reporting entity agrees to purchase shares at the prevailing market price   |
| Accelerated share repurchase (ASR)<br>(FG 9.2.4) | A transaction executed between a reporting entity and an investment bank in which the reporting entity repurchases a large number of shares at a purchase price determined by an average market price over a period of time |
| Written put option<br>(FG 9.2.5)                 | Reporting entity must buy its shares at a specified price if the option holder elects to exercise its option  |

### **9.2.1 Recognition date of share repurchase transactions**

A share repurchase arrangement accounted for as a liability within the scope of ASC 480, *Distinguishing Liabilities from Equity* should be recognized on its trade date. A share repurchase arrangement accounted for as a derivative within the scope of ASC 815, *Derivatives and Hedging* should also be recognized on its trade date. All other share repurchase arrangements should be accounted for on the settlement date of the transaction.

### **9.2.2 Forward repurchase contracts**

A forward repurchase contract obligates the reporting entity to buy its own shares at a future date; therefore, it may be a liability within the scope of ASC 480. The accounting treatment for a forward repurchase contract depends on the settlement alternatives built into the contract and the nature of the reporting entity's obligation to repurchase its shares. See FG 5.5 for information on ASC 480.

#### **9.2.2.1 Physically settled forward repurchase contracts**

A forward repurchase contract that, by its terms, must be physically settled by delivering cash in exchange for a fixed number of the reporting entity's shares should be recorded as a liability under the guidance in ASC 480. ASC 480-10-30-3 through ASC 480-10-30-5 provide guidance regarding the initial measurement and recognition for such a physically settled forward repurchase contract. It is essentially accounted for as a financed purchase of treasury stock.

**ASC 480-10-30-3**

Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash shall be measured initially at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges.

**ASC 480-10-30-4**

Two ways to obtain the adjusted fair value include:

- a. Determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately
- b. Discounting the settlement amount, at the rate implicit at inception after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction.

**ASC 480-10-30-5**

Equity shall be reduced by an amount equal to the fair value of the shares at inception.

To recognize a physically settled forward repurchase contract to buy a fixed number of shares for a fixed amount of cash, a reporting entity should debit treasury stock and credit a share repurchase (forward contract) liability at trade date based on the guidance in ASC 480-10-25-8 and ASC 480-10-30-5.

The subsequent measurement of a physically settled forward repurchase contract depends on whether the amount to be paid and the settlement date are fixed or can vary. ASC 480-10-35-3 provides guidance regarding the subsequent measurement and recognition of a physically settled forward repurchase contract.

**ASC 480-10-35-3**

Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash and mandatorily redeemable financial instruments shall be measured subsequently in either of the following ways:

- a. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.
- b. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

To subsequently account for a physically settled forward contract with a fixed maturity date and a fixed price (common among forward repurchase contracts), a reporting entity should recognize the financing cost embedded in the forward repurchase contract by amortizing the discount to the forward price recorded at inception. To do this, a reporting entity should debit interest cost and credit the share repurchase (forward contract) liability.



See FSP 7.4.3.6 for information related to earnings per share considerations.

### *Application example*

Example FG 9-1 illustrates the accounting for a fixed rate, physically settled forward repurchase contract that settles on a specific date.

### **EXAMPLE FG 9-1**

#### *Accounting for a physically settled fixed rate forward repurchase contract that settles on a specific date*

FG Corp enters into a forward repurchase contract with a bank. FG Corp is required to physically settle the contract. It must pay cash to the bank in exchange for the shares.

Under the terms of the forward contract, FG Corp is obligated to purchase 1,000 shares of its own stock at a price of \$125 per share in one year (total settlement price is 1,000 shares  $\times$  \$125 = \$125,000). FG Corp's stock price on the date the contract is entered into is \$122.50; therefore, there is a financing cost of \$2,500 embedded in the forward contract as discussed in FG 9.2.2.1. The effective interest rate is 2.04%, which represents the discount rate that equates the settlement price in one year with the current stock price on the contract's trade date (the fair value of the underlying shares at inception). FG Corp calculates the amount of interest expense for the first quarter based on the effective interest rate as \$620.

At the inception of the contract, FG Corp accounts for the trade as a financed purchase of treasury shares.

How does FG Corp measure and record the physically settled forward repurchase contract (a) at commencement of the forward repurchase contract, (b) in its quarterly financial statements three months after entering into the forward contract, and (c) at settlement?

#### *Analysis*

To record the physically settled forward repurchase contract at inception, FG Corp records a reduction in equity equal to the current fair value of the shares underlying the contract ( $\$122.50 \times 1,000$  shares = \$122,500) and a corresponding share repurchase liability.

|                                |           |           |
|--------------------------------|-----------|-----------|
| Dr. Treasury stock             | \$122,500 |           |
| Cr. Share repurchase liability |           | \$122,500 |

To prepare its quarterly financial statements three months after entering into the forward contract, FG Corp calculates the quarterly amortization of the \$2,500 discount created at inception using the effective yield approach.

FG Corp records the amortization to the share repurchase liability with an offsetting entry to interest expense.

|                                |       |       |
|--------------------------------|-------|-------|
| Dr. Interest expense           | \$620 |       |
| Cr. Share repurchase liability |       | \$620 |

Upon settlement of the forward repurchase contract, FG Corp records the payment of cash to the bank to settle the share repurchase liability.

|                                |           |           |
|--------------------------------|-----------|-----------|
| Dr. Share repurchase liability | \$125,000 |           |
| Cr. Cash                       |           | \$125,000 |

FG Corp should also consider whether the forward repurchase contract has an effect on its earnings per share. Since the forward contract is accounted for as a financed purchase of treasury stock within the scope of ASC 480, the shares underlying the forward contract should be deducted from weighted average common shares outstanding when calculating basic and diluted earnings per share from inception of the forward repurchase contract.

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ASC 480-10-55-14 through ASC 480-10-55-17 provide another example of how a physically settled fixed rate and date forward repurchase contract should be measured and accounted for at inception and in subsequent periods.

#### **9.2.2.2 Net cash or net share settled forward repurchase contracts**

ASC 480-10-55-17 provides guidance regarding the initial recognition and subsequent measurement of a forward repurchase contract that (1) either permits or requires net cash or net share settlement, or (2) requires physical settlement for specified quantities of assets other than cash.

##### **ASC 480-10-55-17**

In contrast to forward purchase contracts that require physical settlement in exchange for cash, forward purchase contracts that require or permit net cash settlement, require or permit net share settlement, or require physical settlement in exchange for specified quantities of assets other than cash are measured initially and subsequently at fair value, as provided in paragraphs 480-10-30-2, 480-10-30-7, 480-10-35-1, and 480-10-35-5 (as applicable), and classified as assets or liabilities depending on the fair value of the contracts on the reporting date.

A forward repurchase contract that permits or requires net cash or net share settlement, or requires physical settlement in exchange for specified quantities of assets other than cash, should be measured at fair value (both initially and subsequently). Changes in the fair value of these forward repurchase contracts should be recorded in net income. A forward repurchase contract that can be net cash or net share settled may be classified as an asset or liability depending on the fair value of the contracts on the reporting date, which will likely depend on the relationship between the contract price, credit risk and the current forward price of the shares.

See FSP 7.5.5.9 (after adoption of ASU 2020-06) or FSP 7.5.5.9A (before adoption of ASU 2020-06) for earnings per share considerations related to net cash or net share settled forward repurchase contracts, including application of the reverse treasury stock method.

### **9.2.2.3 *Prepaid forward repurchase contracts***

A prepaid forward purchase contract requires the reporting entity to pay the total amount it owes at the time the parties enter into the contract in exchange for the future delivery of a fixed or variable number of common shares. A prepaid forward purchase contract is not a liability pursuant to ASC 480 if the reporting entity has no further obligation to either transfer assets or issue shares to the seller.

Prepaid forward purchase contracts are hybrid instruments consisting of a loan to the counterparty and an embedded forward purchase contract on the reporting entity's own common stock. The embedded derivative should be assessed to determine whether it should be bifurcated under ASC 815. See FG 5.4 for guidance on assessing embedded equity linked components.

Provided the embedded forward purchase contract on a fixed number of common shares does not need to be bifurcated and accounted for separately, we believe it should be reported as a reduction of equity, consistent with the guidance on loans to shareholders in ASC 505-10-45-2 and the treatment of gross physically settled forward purchase contracts (see FG 9.2.2.1). We also believe that the EPS guidance for gross settling forward repurchase contracts should be applied to prepaid forward purchase contracts on an entity's own stock (see FG 9.2.2.1).

### **9.2.3 *Spot repurchases***

A reporting entity may choose to execute a share repurchase by acquiring its common shares in the open market (a spot repurchase). A spot repurchase transaction may be executed by the reporting entity or through a broker for regular-way settlement (typically 2-3 days).

A spot repurchase agreement that (1) unconditionally obligates a reporting entity to repurchase a fixed number of its own shares in exchange for cash and (2) requires physical settlement should be accounted for as a liability under ASC 480 on the trade date (see FG 9.2.2.1). In other words, a spot repurchase transaction should be recorded as of the trade date with a corresponding liability.

It is common for a reporting entity to instruct a third-party broker to purchase its shares in the open market at the prevailing market price up to a fixed-dollar amount. This type of broker-assisted trade should not be recorded until such time as the broker has executed a purchase transaction. If at any point the reporting entity is unconditionally obligated to purchase a fixed number of its shares for a fixed amount of cash (e.g., upon the broker executing a purchase of some or all of the shares pursuant to the order), recognition of a liability with a corresponding reduction of equity may be appropriate based on the guidance in ASC 480. In practice, such transactions are generally limited to a relatively small number of shares, and settlement occurs within a short period of time (e.g., two days).

### **9.2.4 *Accelerated share repurchase (ASR) programs***

An accelerated share repurchase (ASR) program is a transaction executed by a reporting entity with an investment bank counterparty. An ASR allows the reporting entity to immediately purchase a large number of common shares at a purchase price determined by an average market price over a fixed period of time. The average market price is generally the volume weighted average price (VWAP), which is an objectively determinable price. One of the primary advantages of an ASR is that it enables

the reporting entity to execute a large treasury stock purchase immediately, while paying a purchase price that mirrors the price achieved by a longer-term repurchase program in the open market.

In its most basic form, an ASR program comprises the following two transactions:

- A treasury stock purchase in which the reporting entity buys a fixed number of common shares and pays the investment bank counterparty the spot share price at the repurchase date
- A forward contract under which the reporting entity either receives or delivers cash or shares (generally at the reporting entity's option) at the contract's maturity date. The value received or delivered by the reporting entity equals the difference between the VWAP over the term of the contract and the spot share price at inception, multiplied by the number of shares repurchased.
  - The reporting entity receives value from the bank if the VWAP is less than the spot share price paid at inception;
  - The reporting entity delivers value to the bank if the VWAP is greater than the spot share price paid at inception

Many ASR programs have terms that vary from this basic transaction and commonly include additional features that may complicate the accounting analysis. Figure FG 9-2 describes some of the more common terms and features.

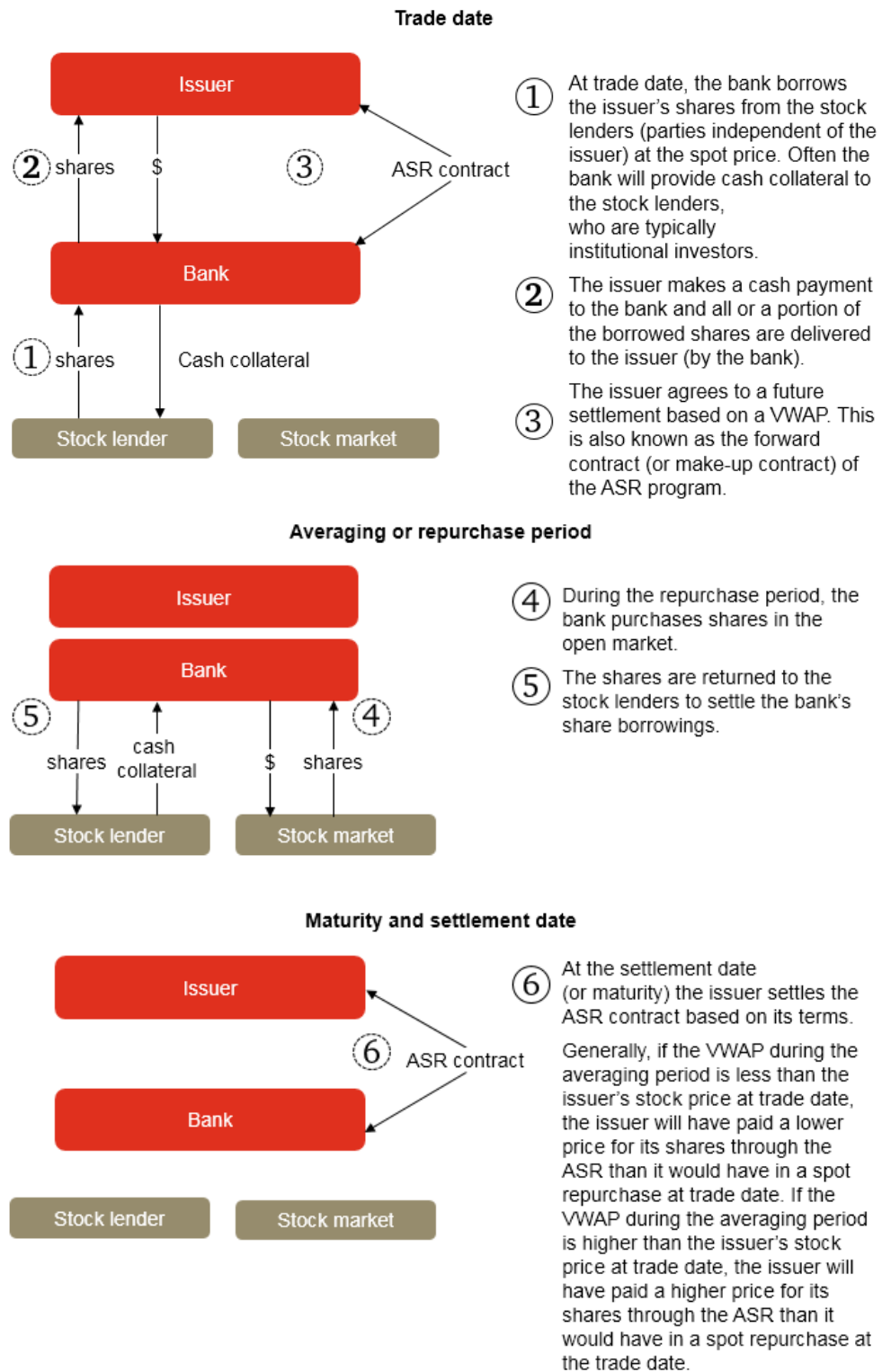
**Figure FG 9-2**  
Common ASR terms and features

| Feature                                 | Description   |
|---|---|
| Fixed dollar vs. fixed share            | <ul style="list-style-type: none"> <li>□ In a fixed dollar ASR, the proceeds paid by the reporting entity are fixed and the number of shares received varies based on the VWAP.</li> <li>□ In a fixed share ASR, the number of shares purchased is fixed and the amount paid for those shares varies based on the VWAP.</li> </ul>  |
| Fixed vs. variable maturity             | <ul style="list-style-type: none"> <li>□ A fixed maturity ASR has a stated maturity date.</li> <li>□ In a variable maturity ASR, the investment bank has the option to choose the maturity date of the ASR, subject to a minimum and maximum maturity. The investment bank pays a premium (which generally takes the form of a discount on the share repurchase price) for this option.</li> <li>□ In a variable maturity, capped, or collared ASR contract, amounts received (paid) are determined based on a settlement formula.</li> </ul> |
| Uncollared, capped, or collared pricing | <ul style="list-style-type: none"> <li>□ In an uncollared ASR, the reporting entity participates in all changes in VWAP over the term of the ASR.</li> <li>□ In a capped ASR, the reporting entity participates in changes in VWAP subject to a cap, which limits the price the reporting entity will pay to repurchase the shares. A cap protects the reporting entity from paying a price for its shares above a stated amount. The reporting entity pays the investment bank a premium for this protection.</li> </ul>                     |

| Feature        | Description   |
|----------------|---|
|                | <ul style="list-style-type: none"> <li>□ In a collared ASR, the reporting entity participates in changes in VWAP subject to a cap and a floor. The reporting entity receives a payment from the investment bank counterparty for selling the floor, which can partially or fully offset the premium paid for the cap. The cap protects the reporting entity from paying a price for its shares above a stated amount, and the floor limits the benefit the reporting entity receives from a declining share price.</li> </ul>   |
| Share holdback | <ul style="list-style-type: none"> <li>□ In an effort to avoid legal and earnings per share complications that arise when a reporting entity delivers shares upon settlement of the forward contract, many reporting entities elect to receive fewer shares than they are entitled to at contract inception. In some cases, the reporting entity may receive staggered partial share deliveries over the term of the forward contract. The partial delivery of shares reduces the likelihood of the reporting entity being required to deliver shares back to the bank to settle the forward contract.</li> </ul> |

Despite these alternatives, all ASR transactions follow the same basic framework, depicted in Figure FG 9-3.

**Figure FG 9-3**  
Illustration of ASR mechanics



### 9.2.4.1 *Initial recognition and measurement*

As discussed in ASC 505-30-25-6, an ASR is generally accounted for as two separate transactions (1) a treasury stock transaction and (2) an equity-linked contract on the reporting entity's own stock (ASR contract). See FG 9.3 for information on accounting for treasury stock transactions.

The ASR contract should first be analyzed to determine whether it should be classified as a liability per ASC 480-10-25-14. An instrument requiring delivery of a variable number of shares is classified as a liability if, at inception, the monetary value of the obligation is based solely or predominantly on (1) a fixed monetary amount known at inception or (2) variations inversely related to changes in the fair value of the reporting entity's equity shares.

In the basic ASR transaction described in FG 9.2.4, a reporting entity could be required to deliver a variable number of shares at maturity of the ASR contract. In this case, the monetary value received or delivered would be equal to (a) the difference between the VWAP over the term of the contract and the spot share price, multiplied by (b) the number of shares purchased at inception. Since the monetary value changes as the VWAP changes, it is not predominantly based on a fixed monetary amount. In addition, the reporting entity could be required to deliver value as the price of its shares (i.e., the VWAP) increases and could receive value as the price of its shares decreases. Therefore, the monetary value is not based on variations inversely related to changes in the fair value of the reporting entity's equity shares.

The monetary value of an ASR contract that incorporates alternatives to the basic structure may be more complicated to determine. Frequently, a quantitative analysis (or predominance test) of the possible settlement outcomes is needed to determine how the monetary value is affected by the terms of the transaction. For example, a variable maturity option reduces the value of the contract from the perspective of the reporting entity. In other words, this feature behaves like a written put option. In the case of an ASR with a variable maturity option, the quantitative analysis may be designed to determine whether the written put component resulting from the variable maturity option is a predominant feature of the population of settlement alternatives. If it is, then the ASR contract may be within the scope of ASC 480.

A quantitative analysis may take into account factors such as:

- The terms of the contract, including the number of shares delivered at inception of the transaction
- The reporting entity's stock price at the trade date
- The volatility of the reporting entity's stock price
- The probability of any cap or floor on the ASR contract being reached

If a reporting entity concludes that an ASR contract is not within the scope of ASC 480, the next step is to determine whether it should be classified as a liability or equity under the guidance in ASC 815-40, *Contracts in Entity's Own Equity*. See FG 5.6 (after adoption of ASU 2020-06) or FG 5.6A (before adoption of ASU 2020-06) for further information on the analysis of a freestanding equity-linked instrument.

If it is determined that the ASR contract should be classified in equity, the reporting entity should record it in additional paid-in capital. See Example FG 9-2 for an illustration of this guidance. If the

ASR contract should be classified as a liability, the reporting entity should record the contract at fair value with changes in fair value recorded in net income.

#### 9.2.4.2 *Settlement of an ASR contract classified in equity*

When an ASR contract classified in equity is settled in cash, the cash payment should be recorded in additional paid-in capital because it is a payment to settle an equity classified contract. Similarly, when an ASR contract is settled in shares, the shares should be recorded at fair value in additional paid-in capital because they are issued (or received) to settle an equity classified contract.

Figure FG 9-4 summarizes the accounting treatment for the various settlement alternatives of an ASR contract.

**Figure FG 9-4**  
Summary of ASR settlement alternatives

| <b>Settlement form</b> | <b>Party owing value</b> | <b>Treatment</b>  |
|------------------------|--------------------------|---|
| Cash                   | Bank                     | Cash payment should be recorded as an increase to additional paid-in capital  |
| Cash                   | Reporting entity         | Cash payment should be recorded as a reduction of additional paid-in capital  |
| Shares                 | Bank                     | Shares should be recorded in treasury stock with an offsetting entry to additional paid-in capital; generally, issuers record the shares at fair value  |
| Shares                 | Reporting entity         | <p>If the reporting entity issues new shares, the shares should be recorded at fair value with an offsetting entry to additional paid-in capital (since the offsetting entry is to additional paid-in capital, on a net basis, it is the equivalent of simply capitalizing the par value)</p> <p>If the reporting entity reissues treasury shares, the guidance for the reissuance of treasury shares should be applied; see FG 9.3.2 for information on the reissuance of treasury stock</p> |

If neither the reporting entity nor the investment bank owes value, there should be no accounting entry. The amount originally recorded related to an equity classified ASR contract should remain in additional paid-in capital.

#### 9.2.4.3 *ASR contract earnings per share—after adoption of ASU 2020-06*

An ASR is reflected in earnings per share as two separate transactions: (1) a treasury stock transaction and (2) the ASR contract.



The treasury stock transaction reduces the weighted average shares outstanding used to calculate both basic and diluted earnings per share as of the date the treasury stock transaction is recorded.

Most ASR contracts give the reporting entity the option to elect to receive, or pay, any value owed under the ASR contract at maturity in cash or shares. The effect of the potential share settlement should be included in the diluted earnings per share calculation using the treasury stock method regardless of whether the settlement election is at the option of the reporting entity or the holder, or whether the reporting entity has a history or policy of cash settlement. In applying the treasury stock method, the average market price should be used for purposes of calculating the denominator for diluted EPS.

The reporting entity should also consider whether the terms of an ASR contract require it to be accounted for as a participating security. In many ASR contracts, the dividends expected to be paid during the term of the ASR contract are included in the forward price. If the reporting entity pays dividends in excess of the expected dividends, this will adversely impact the economics of the ASR transaction for the bank counterparty. To protect against this, the bank counterparty will typically have an option to terminate the ASR contract upon the declaration of the “excess” dividend. If instead, the ASR contract protects the bank counterparty by requiring the reporting entity to pay the difference between the expected and actual dividends paid during the term of the ASR contract to the bank counterparty, the ASR contract is a participating security, and application of the two-class method of calculating earnings per share should be applied. See FSP 7.4.2 for information on participating securities and the two-class method of calculating earnings per share.

#### **9.2.4.3A ASR contract earnings per share—before adoption of ASU 2020-06**

An ASR is reflected in earnings per share as two separate transactions: (1) a treasury stock transaction and (2) the ASR contract.

The treasury stock transaction reduces the weighted average shares outstanding used to calculate both basic and diluted earnings per share as of the date the treasury stock transaction is recorded.

The ASR contract is generally included in diluted earnings per share using the treasury stock method; however, the reporting entity should consider (1) the terms of the specific ASR program and (2) the reporting entity’s specific facts and circumstances to determine the appropriate earnings per share treatment. Most ASR contracts give the reporting entity the option to elect to receive, or pay, any value owed under the ASR contract at maturity in cash or shares. If a reporting entity has established a pattern of settling such ASR contracts in cash, the treasury stock method may not be appropriate based on the guidance in ASC 260-10-55-32 through ASC 260-10-55-36A for instruments settleable in cash or shares. See FSP 7.5.7.1A for further information.

The reporting entity should also consider whether the terms of an ASR contract require it to be accounted for as a participating security. In many ASR contracts, the dividends expected to be paid during the term of the ASR contract are included in the forward price. If the reporting entity pays dividends in excess of the expected dividends, this will adversely impact the economics of the ASR transaction for the bank counterparty. To protect against this, the bank counterparty will typically have an option to terminate the ASR contract upon the declaration of the “excess” dividend. If instead, the ASR contract protects the bank counterparty by requiring the reporting entity to pay the difference between the expected and actual dividends paid during the term of the ASR contract to the bank counterparty, the ASR contract is a participating security, and application of the two-class method of

calculating earnings per share should be applied. See FSP 7.4.2 for information on participating securities and the two-class method of calculating earnings per share.

#### 9.2.4.4 *Application example*

Example FG 9-2 illustrates the accounting for an ASR contract.

#### **EXAMPLE FG 9-2**

##### *Accounting for an ASR contract*

On September 30, 20X1, when its common stock price is \$125 per share, FG Corp enters into an ASR program with the following terms:

- The ASR is a fixed dollar program in which FG Corp will deliver \$10 million to the bank on September 30, 20X1 to repurchase a variable number of common shares. The variable number of shares will be determined by dividing the \$10 million contract amount by the VWAP observed during the term of the ASR contract.
- The bank delivers 76,000 shares to FG Corp on September 30, 20X1.
- FG Corp is not obligated to deliver any cash to the bank after the initial cash delivery of \$10 million. FG Corp analyzes the ASR contract and determines that it is not a liability within the scope of ASC 480. In addition, FG Corp concludes that the ASR contract meets the requirements for equity classification. The amount recorded related to the ASR contract after the cash payment and initial share delivery is \$500,000 [ $\$10 \text{ million} - (76,000 \text{ shares} \times \$125)$ ].

The contract matures on March 31, 20X2, and the VWAP over the ASR term is \$117. At maturity, FG Corp receives an additional 9,470 shares ( $[\$10 \text{ million} \div \$117 = 85,470]$  less 76,000 initial share delivery), at which time FG Corp's stock price is \$110 per share.

What journal entries should FG Corp record at the inception and settlement of the ASR transaction?

##### *Analysis*

When FG Corp enters into the ASR contract, it should record (1) treasury stock equal to the shares repurchased multiplied by the then current stock price ( $76,000 \times \$125 = \$9,500,000$ ), (2) the ASR contract in additional paid-in capital, and (3) the cash payment made.

|   |             |              |
|---|-------------|--------------|
| Dr. Treasury stock                      | \$9,500,000 |              |
| Dr. Equity – additional paid-in capital | \$500,000   |              |
| Cr. Cash                                |             | \$10,000,000 |

When FG Corp settles the ASR contract, it should record (1) treasury stock equal to the shares received multiplied by the current stock price ( $9,470 \times \$110 = \$1,041,700$ ) and (2) an offsetting entry to additional paid-in capital.

|   |             |             |
|---|-------------|-------------|
| Dr. Treasury stock                      | \$1,041,700 |             |
| Cr. Equity – additional paid-in capital |             | \$1,041,700 |

### 9.2.5 *Written put option*

When a reporting entity writes a put option on its own shares, it agrees to buy the shares from a counterparty, generally in exchange for cash, when its share price falls below a specified price. In return, the counterparty pays the reporting entity a premium for entering into the written put option. Generally, a put option has a strike price below the share price at inception (i.e., it is out-of-the-money).

Regardless of the form of settlement, a written put option on a reporting entity's own shares is a liability within the scope of ASC 480. See FG 5.5 for further information on the scope of ASC 480.

A written put option on a reporting entity's own shares should be recorded at fair value with changes in fair value recorded in net income.

See FSP 7.5.5.9 (after adoption of ASU 2020-06) or FSP 7.5.5.9A (before adoption of ASU 2020-06) for earnings per share considerations related to written put options, including application of the reverse treasury stock method.

## 9.3 *Treasury stock*

As discussed in ASC 505-30, *Treasury Stock*, when a reporting entity repurchases its common shares it may account for the shares as treasury stock or retire them. See FG 9.4 for information on share retirement.

ASC 505-30-30-6 provides guidance on recording treasury stock.

### **ASC 505-30-30-6**

Once the cost of the treasury shares is determined under the requirements of this Section, and if a corporation's stock is acquired for purposes other than retirement (formal or constructive), or if ultimate disposition has not yet been decided, paragraph 505-30-45-1 permits the cost of acquired stock to either be shown separately as a deduction from the total of capital stock, additional paid-in capital, and retained earnings, or be accorded the following accounting treatment appropriate for retired stock.

However, when a reporting entity acquires its own stock, it should consult with its legal counsel to determine if the laws in the state of incorporation are different than the requirements under ASC 505-30. In such instances, ASC 505-30-25-2 indicates the reporting entity should apply the accounting dictated by the applicable laws.

**ASC 505-30-25-2**

Laws of some states govern the circumstances under which an entity may acquire its own stock and prescribe the accounting treatment therefor. If such requirements are at variance with the requirements of paragraphs 505-30-25-7 and 505-30-30-6 through 30-10, the accounting shall conform to the applicable law.

**9.3.1 Accounting for the purchase of treasury stock**

A reporting entity should recognize treasury stock based on the amount paid to repurchase its shares. It should be recorded as a reduction of stockholders' equity (i.e., as a contra-equity account). Since treasury stock is not considered outstanding for share count purposes, it should be excluded from average common shares outstanding for basic and diluted earnings per share.

Although the cost of the treasury stock is generally the price paid for the shares, a reporting entity should consider whether the price paid for the shares includes payment for other agreements, rights, and privileges. See FG 9.3.4 for further information on multiple element treasury stock transactions. Direct costs incurred to acquire treasury stock should be treated like stock issue costs and added to the cost of the treasury stock by analogy to the guidance provided in the AICPA Q&A Section 4110.09.

**9.3.2 Accounting for reissuance of treasury stock**

When a reporting entity reissues treasury stock at an amount greater (less) than it paid to repurchase the shares (based on its policy such as average cost, FIFO, LIFO, or specific identification), it realizes a gain (loss) on the reissuance of the shares. This gain or loss should be recognized in shareholders' equity, not net income. A gain on the reissuance of treasury shares should be credited to additional paid-in capital. A loss on the reissuance of treasury shares may be debited to additional paid-in capital to the extent previous net gains from sales or retirements of the same class of stock are included in additional paid-in capital. Any losses in excess of that amount should be charged to retained earnings.

**9.3.3 Application example**

Example FG 9-3 illustrates the accounting for the purchase and subsequent reissuance of treasury stock.

**EXAMPLE FG 9-3****Accounting for the purchase and subsequent reissuance of treasury stock**

FG Corp repurchases 2,000 shares of its common stock at a price of \$40 per share. The shares are recorded as treasury stock and are not formally retired.

Six months after purchasing the treasury shares, FG Corp reissues 1,000 shares of treasury stock at a price of \$45 per share. The remaining 1,000 shares of treasury stock are reissued two months after that at a price of \$28 per share.

How should FG Corp account for the purchase and reissuance of treasury stock?

*Analysis*

When FG Corp executes the treasury stock purchase, it should record the treasury shares based on its cost (2,000 shares x \$40) by recording the following journal entry.

|                    |          |          |
|--------------------|----------|----------|
| Dr. Treasury stock | \$80,000 |          |
| Cr. Cash           |          | \$80,000 |

When FG Corp reissues 1,000 shares of treasury stock for \$45 per share, it should reduce treasury stock for an amount equal to the initial cost and record the reissuance gain in additional paid-in capital (1,000 shares x \$5) by recording the following journal entry.

|                                |          |          |
|--------------------------------|----------|----------|
| Dr. Cash                       | \$45,000 |          |
| Cr. Treasury stock             |          | \$40,000 |
| Cr. Additional paid-in capital |          | \$5,000  |

When FG Corp reissues the remaining 1,000 shares of treasury stock at \$28 per share, it should reduce treasury stock at an amount equal to its initial cost (1,000 shares x \$40) and record the reissuance loss in additional paid-in capital to the extent of prior reissuance gains (\$5,000). The remaining reissuance loss [(1,000 shares x (\$40-\$28)) - \$5,000] should be charged to retained earnings by recording the following journal entry.

|                                |          |          |
|--------------------------------|----------|----------|
| Dr. Cash                       | \$28,000 |          |
| Dr. Additional paid-in capital | \$5,000  |          |
| Dr. Retained earnings          | \$7,000  |          |
| Cr. Treasury stock             |          | \$40,000 |

Question FG 9-1 discusses how a reporting entity with an accumulated deficit should record a loss on the reissuance of treasury stock.

### Question FG 9-1

How should a reporting entity with an accumulated deficit record a loss on the reissuance of treasury stock?

***PwC response***

We believe a reporting entity with an accumulated deficit should analogize to the guidance in SAB Topic 3.C, *Redeemable Preferred Stock* (as codified in ASC 480-10-S99-2), and record a loss on the reissuance of treasury stock to additional paid-in capital until there is none left. Once additional paid-in capital has been depleted, additional losses should be recorded by increasing the accumulated deficit.

### 9.3.4 *Multiple element treasury stock transactions*

Sometimes, the facts and circumstances of a share repurchase suggest that the transaction involves more than the purchase of treasury stock. For example, a reporting entity may repurchase shares at a price greater, or less than, fair value. As discussed in ASC 505-30-30-3, when a reporting entity pays more than the fair value of the acquired treasury stock, the excess should be attributed to the other elements of the transaction.

#### **ASC 505-30-30-3**

For example, the selling shareholder may agree to abandon certain acquisition plans, forego other planned transactions, settle litigation, settle employment contracts, or restrict voluntarily the ability to purchase shares of the entity or its affiliates within a stated time period. If the purchase of treasury shares includes the receipt of stated or unstated rights, privileges, or agreements in addition to the capital stock, only the amount representing the fair value of the treasury shares at the date the major terms of the agreement to purchase the shares are reached shall be accounted for as the cost of the shares acquired. The price paid in excess of the amount accounted for as the cost of the treasury shares shall be attributed to the other elements of the transaction and accounted for according to their substance. If the fair value of those other elements of the transaction is more clearly evident, for example, because the entity's shares are not publicly traded, that amount shall be assigned to those elements and the difference recorded as the cost of treasury shares. If no stated or unstated consideration in addition to the capital stock can be identified, the entire purchase price shall be accounted for as the cost of treasury shares.

In a multiple element treasury stock arrangement, the cost of a public company's treasury stock should generally be the quoted market price of the shares. The SEC staff has generally objected to the use of other valuation methods. The cost of private company shares may be more subjective. A reporting entity should consider the facts and circumstances of the transaction including the relative observability of the fair value of the elements of the transaction.

If there are no other elements to be accounted for separately, we believe the entire amount paid by the reporting entity to acquire treasury shares should be included in the recorded cost.

#### 9.3.4.1 *Treasury stock transactions involving a standstill agreement*

A reporting entity may enter into a standstill agreement as a hostile takeover defense mechanism. A standstill agreement precludes a hostile bidder from purchasing additional shares of the reporting entity's stock for a specified period of time.

Often, the reporting entity also agrees to repurchase its shares from the bidder at a later date, typically at a premium. These agreements are commonly referred to as "greenmail transactions." When a reporting entity agrees to buy back its shares at a premium, it should separate the amount paid into (1) the cost to defend itself from a takeover attempt, and (2) the cost to repurchase its shares. Costs incurred to defend itself from a takeover attempt, including any premium paid to a hostile bidder, should be expensed as incurred, as required by ASC 505-30-25-4, as normal operating costs.

#### **9.3.4.2 *Litigation settlements involving the purchase of shares***

A litigation settlement may involve a purchase of shares. For example, a reporting entity may purchase its shares from an existing shareholder at a price in excess of its then fair value at the time it agrees to settle pending litigation. If the substance of an arrangement is that the reporting entity is settling litigation with a shareholder, then the excess value should be attributed to the litigation settlement. See FG 9.3.4 for information on multiple element treasury stock transactions.

#### **9.3.4.3 *Repurchases of stock held by employees at other than fair value***

When a reporting entity repurchases its shares from employees as part of an employee stock ownership or other arrangement, the reporting entity should assess whether the price paid results in compensation expense. See SC 4.8.1 for information on repurchases of stock held by an employee.

#### **9.3.5 *Dividends on treasury stock***

Typically, cash dividends are not declared and paid on treasury stock unless the treasury shares are underlying a forward share repurchase contract. If a reporting entity does declare a cash dividend on treasury stock that it holds, the dividend should be deducted from the dividend distribution and should not be recorded as investment income. That is, the entry to charge retained earnings and credit cash for the dividends paid on treasury stock is eliminated since the cash remains with the reporting entity.

##### **9.3.5.1 *Stock dividends on treasury stock***

Applicable state laws govern the issuance of stock dividends on treasury stock. Some statutes prohibit this practice. When treasury stock is not retired and is held with the expectation that it will be reissued for a specific purpose (e.g., stock option, purchase, or bonus plans), it may be important to maintain the same ratio of treasury shares to total shares outstanding before and after a stock dividend. In that case, issuance of a stock dividend on treasury stock may be appropriate if permitted by law. When the ratio of treasury shares to total shares does not need to be retained, issuance of stock dividends on the treasury stock is not necessary.

We believe a reporting entity should record the dividend using the legal minimum (par value). However, in some cases, recording a stock dividend at the legal minimum may conflict with stock exchange or regulatory authority requirements. In that case, the reporting entity may record the dividend applicable to treasury stock at the fair value of the shares paid as a dividend. See FG 4.4.4 and FG 7.7.1 for further information on stock dividends.

The cost basis of shares recorded as treasury stock does not change based on how the reporting entity recorded the dividend. The original cost to acquire the treasury stock should be allocated to the total number of shares held in treasury, including the dividend shares.

##### **9.3.6 *Treasury stock issued to pay a stock dividend***

When treasury stock is issued to pay all or a portion of a stock dividend, the dividend should be recorded at an amount equal to the fair value of the shares on the dividend declaration date. The reissuance of the treasury shares should be accounted for in the same manner as other reissuances of treasury stock. See FG 9.3.2 for information on the reissuance of treasury stock.

## 9.4 Share retirement

A reporting entity may decide, or be required by state law, to retire the common shares it acquires. When shares are retired, the number of issued and outstanding shares decreases; retired shares are equivalent to authorized, unissued shares.

To retire shares, a reporting entity should debit the common stock account for an amount equal to the number of shares being retired multiplied by the par or stated value. ASC 505-30-30-8 provides guidance on how to account for the amount paid to repurchase the shares in excess of the par or stated value. Figure FG 9-5 summarizes the methods described in ASC 505-30-30-8.

### Figure FG 9-5

Methods of accounting for a repurchase price paid in excess of par or stated value

| Method   | Summary  |
|--|--|
| Retained earnings                              | Record the excess entirely in retained earnings  |
| Retained earnings / additional paid-in capital | Allocate the excess between retained earnings and additional paid-in capital; the balance recorded in APIC is limited as discussed below |

We also believe that the excess can be recorded entirely in additional paid-in capital (although the balance recorded to APIC is limited as discussed below). This method is not explicitly mentioned in ASC 505-30-30-8; however, it was contained in the guidance in ARB 43, and we believe it may still be applied.

If a reporting entity chooses to record an amount to additional paid-in capital, it should be limited as discussed in ASC 505-30-30-8.

#### Excerpt from ASC 505-30-30-8

If a portion of the excess is allocated to additional paid-in capital, it shall be limited to the sum of both of the following:

- a. All additional paid-in capital arising from previous retirements and net gains on sales of treasury stock of the same issue
- b. The pro rata portion of additional paid-in capital, voluntary transfers of retained earnings, capitalization of stock dividends, and so forth, on the same issue. For this purpose, any remaining additional paid-in capital applicable to issues fully retired (formal or constructive) is deemed to be applicable pro rata to shares of common stock.

A reporting entity should elect one method and follow it consistently. The method elected should be disclosed in the reporting entity's financial statements if considered to be a significant accounting policy.



If a reporting entity repurchases shares for retirement at a price less than the par or stated value, the difference between the par or stated value and the cost of the treasury stock should be credited to additional paid-in capital as discussed in ASC 505-30-30-9.

When a reporting entity retires shares, it should consider consulting legal counsel to make sure that its accounting entries and financial statements conform to applicable state laws, including whether the share retirement results in a reduction of the number of authorized shares.

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***Chapter 10:  
ASU 2020-06 effective date  
and transition—added  
February 2021***

## 10.1 ASU 2020-06 transition overview

In August 2020, the FASB issued 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)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the “own stock” scope exception (see FG 5) and certain aspects of the EPS guidance.

This chapter discusses the effective date and transition requirements, including the transition disclosures, related to the adoption of ASU 2020-06.

## 10.2 ASU 2020-06 effective date

Figure FG 10-1 summarizes the effective dates for adopting ASU 2020-06. Early adoption is permitted for both public and nonpublic business entities.

### Figure FG 10-1

#### Effective dates of ASU 2020-06

| Type of reporting entity  | Effective date   |
|---|--|
| Public business entities that are SEC filers and are not eligible to be smaller reporting companies<br><br>For purposes of this ASU, the one-time determination of whether an entity is eligible to be a smaller reporting company in accordance with SEC regulations is based on an entity’s most recent determination as of August 5, 2020. | Fiscal years, including interim periods within those fiscal years, beginning after December 15, 2021 |
| All other entities  | Fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023 |

### Early adoption provisions

Early adoption of ASU 2020-06 is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. A reporting entity is not permitted to adopt the guidance in an interim period, other than the first interim period of its fiscal year. For example, if a calendar year public business entity (other than a smaller reporting company) wishes to adopt ASU 2020-06 early, it would have to adopt the new guidance as of the beginning of the first quarter of 2021. Otherwise, it must adopt the guidance as of the beginning of calendar year 2022.

Early adoption is permitted only on an entity-wide basis and cannot be elected for selected instruments with one exception for certain instruments with down round features. A reporting entity that has not yet adopted the amendments to the guidance for accounting for certain instruments with down round features in ASU 2017-11 may adopt the recognition and measurement amendments in ASU 2020-06 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. See FG 5.6.2.2, FG 5.6.2.2A and FG 7.3.2.2 for further information on down round features.

## **10.3 ASU 2020-06 transition approach**

ASU 2020-06 requires adoption using one of following two methods:

- **Modified retrospective method:** Apply the ASU to financial instruments outstanding as of the beginning of the fiscal year of adoption, with the cumulative effect of adoption recognized at the date of initial application through an adjustment to the opening balance of retained earnings. Under this method, EPS amounts are not restated in prior periods presented. For example, if a calendar year public business entity early adopts the ASU, the cumulative effect of adoption would be recognized on January 1, 2021.
- **Full retrospective method:** Apply the ASU to financial instruments outstanding as of the beginning of the first comparative reporting period presented and financial instruments issued thereafter in accordance with the guidance on accounting changes in ASC 250-10-45-5 through ASC 250-10-45-10. Under this method, EPS for all prior comparative reporting periods should be restated.

Both methods of adoption require a reporting entity to calculate the impact of adopting the new guidance assuming they had been applying the ASU as of the issuance date for all instruments outstanding as of:

- the date of adoption (e.g., January 1, 2022 for a calendar year public business entity that does not early adopt) for a reporting entity electing the modified retrospective method, or
- the beginning of the first comparative reporting period presented for a reporting entity electing the full retrospective method.

ASC 815-40-65-1(d) also allows a reporting entity to make a one-time irrevocable election to apply the fair value option in ASC 825-10 as of the date of adoption for any liability classified convertible securities that are within the scope of ASC 825-10. The impact of electing the fair value option would be reflected through a cumulative effect adjustment to the opening retained earnings balance as of the beginning of the first reporting period a reporting entity adopted ASU 2020-06.

The new guidance requires reporting entities to assume share settlement, when an instrument can be settled in cash or shares at the reporting entity's option, for purposes of computing diluted EPS.

### **10.3.1 Transition for convertible instruments**

The ASU simplifies the accounting for convertible instruments by eliminating the cash conversion and the beneficial conversion feature (BCF) accounting models for convertible debt and convertible preferred stock.

#### **10.3.1.1 Transition for convertible debt with cash conversion**

The cash conversion model before the adoption of ASU 2020-06 is applicable to a convertible debt instrument when (1) the conversion option is not required to be separately accounted for as a

bifurcated derivative pursuant to ASC 815-15, and (2) the instrument by its stated terms may be settled in cash (or other assets) upon conversion, in whole or in part. The objective of this model is to report an interest cost that is comparable to that which would have been incurred had the reporting entity issued debt without a conversion option. This is achieved by separating the equity component (conversion option) from the liability component, thereby creating a discount on the debt, which is then amortized through interest expense over the expected life of the instrument. See FG 6.6A for further information on convertible debt with a cash conversion feature before adoption of ASU 2020-06.

The elimination of the cash conversion sub-sections of ASC 470-20 results in these instruments being recorded as a single liability. As a result, the discount created by recognition of a component of the convertible debt in equity is eliminated and interest expense is reduced. As discussed in Question FG 10-1, the change in interest expense may also impact capitalized interest. Adjustments to previously recorded interest expense may also impact book/tax differences and deferred tax balances.

Example FG 10-1 illustrates the accounting as of the transition date for a convertible debt instrument with a cash conversion feature.

### EXAMPLE FG 10-1

#### Transition of convertible debt with cash conversion feature upon adoption of ASU 2020-06

FG Corp, a calendar year-end public company, adopts ASU 2020-06 on January 1, 20X4. At the adoption date, FG Corp has convertible debt outstanding, which was issued on January 1, 20X1. Information about this debt is summarized in the following table.

|  |  |
|--|--|
| Convertible debt issuance date         | January 1, 20X1  |
| FG Corp's stock price at issuance date | \$85   |
| Principal amount                       | \$1,000  |
| Coupon rate                            | 2% paid annually on December 31  |
| Years to maturity                      | 7 years  |
| Issuer call option                     | 2 years and thereafter   |
| Investor put option                    | 5 years and thereafter   |
| Conversion price                       | \$100  |
| Conversion terms                       | Investors can convert in any quarter following a quarter in which FG Corp's stock price traded at or above \$110 for at least 45 days  |
| Conversion settlement                  | Upon conversion, the investor will receive the principal amount (i.e., \$1,000) in cash and net shares equal to value, if any, due to the conversion option being in the money |

This example ignores the effects of debt issuance costs, accrued interest, and income taxes for simplicity.

How should FG Corp transition the convertible debt outstanding at the ASU 2020-06 adoption date under (1) the modified retrospective method, and (2) the full retrospective method?

### *Analysis*

#### **Before adoption of ASU 2020-06**

##### *At convertible debt issuance date (January 1, 20X1)*

At the issuance date (i.e., January 1, 20X1), FG Corp concludes that the convertible debt is within the scope of the cash conversion guidance in ASC 470-20 and should be separated into its debt and equity components.

FG Corp determines that a nonconvertible debt instrument with the same terms would have an expected life of five years because its debt instrument is puttable by investors at the beginning of year six. Based on its analysis of 5-year nonconvertible debt with similar terms issued by companies with similar credit quality, FG Corp determines the coupon rate for a nonconvertible debt instrument with the same terms to be 8.02%. Using a present value calculation, FG Corp determines the initial carrying value of the debt as \$760. The residual amount of proceeds allocated to the equity component is therefore \$240 (the difference between the \$1,000 proceeds and \$760 debt liability).

The debt balance at the beginning and end of each year, along with the annual amortization of the discount on the debt using the effective interest method, is shown in the following table.

|  | 20X1  | 20X2  | 20X3  | 20X4  | 20X5    | Total |
|--|-------|-------|-------|-------|---------|-------|
| <b>Debt balance at beginning of period<sup>(1)</sup></b> | \$760 | \$801 | \$845 | \$893 | \$944   |       |
| <b>Amortization of discount on debt<sup>(2)</sup></b>    | 41    | 44    | 48    | 51    | 56      | 240   |
| <b>Debt balance at end of period<sup>(1)</sup></b>       | \$801 | \$845 | \$893 | \$944 | \$1,000 |       |

(1) The present value of the remaining \$20 annual coupon payments ( $\$1,000 \times 2\% = \$20$ ) plus present value of \$1,000 principal payment at the end of the fifth year using 8.02% annual discount rate.

(2) Debt balance at the end of the year minus debt balance at the beginning of the year.

FG Corp records the following journal entry on January 1, 20X1 to recognize the receipt of cash proceeds from the issuance of the convertible debt instrument and its separation into liability and residual equity components.

|  |         |         |
|--|---------|---------|
| Dr. Cash   | \$1,000 |         |
| Dr. Convertible debt discount                      | \$240   |         |
| Cr. Convertible debt                               |         | \$1,000 |
| Cr. Additional paid-in capital (conversion option) |         | \$240   |

*During the first year (20X1)*

FG Corp records the following journal entry to recognize the amortization of the debt discount and payment of interest.

|                               |      |      |
|-------------------------------|------|------|
| Dr. Interest expense          | \$61 |      |
| Cr. Cash                      |      | \$20 |
| Cr. Convertible debt discount |      | \$41 |

*During the second year (20X2)*

FG Corp records the following journal entry to recognize the amortization of the debt discount and payment of interest.

|                               |      |      |
|-------------------------------|------|------|
| Dr. Interest expense          | \$64 |      |
| Cr. Cash                      |      | \$20 |
| Cr. Convertible debt discount |      | \$44 |

*During the third year (20X3)*

FG Corp records the following journal entry to recognize the amortization of the debt discount and payment of interest.

|                               |      |      |
|-------------------------------|------|------|
| Dr. Interest expense          | \$68 |      |
| Cr. Cash                      |      | \$20 |
| Cr. Convertible debt discount |      | \$48 |

The following table summarizes FG Corp's balance sheet and income statement as of and for the years ended December 31, 20X1, 20X2, and 20X3 (assume the convertible debt is FG Corp's only contract).

**Before ASU 2020-06**

|  | 20X1                | 20X2                 | 20X3                 |
|--|---------------------|----------------------|----------------------|
| <b>Balance sheets</b>                          |                     |                      |                      |
| Cash   | \$980               | \$960                | \$940                |
| Total assets                                   | <u>980</u>          | <u>960</u>           | <u>940</u>           |
| Convertible debt                               | 1,000               | 1,000                | 1,000                |
| Convertible debt discount                      | (199)               | (155)                | (107)                |
| Total liabilities                              | 801 <sup>(1)</sup>  | 845 <sup>(1)</sup>   | 893 <sup>(1)</sup>   |
| Additional paid-in capital (conversion option) | 240                 | 240                  | 240                  |
| Retained earnings                              | (61) <sup>(2)</sup> | (125) <sup>(2)</sup> | (193) <sup>(2)</sup> |
| Total stockholders' equity                     | 179                 | 115                  | 47                   |
| Total liabilities and stockholders' equity     | <u>980</u>          | <u>960</u>           | <u>940</u>           |
| <b>Income statements</b>                       |                     |                      |                      |
| Interest expense                               | 61                  | 64                   | 68                   |
| Net loss                                       | <u>(\$61)</u>       | <u>(\$64)</u>        | <u>(\$68)</u>        |

(1) Convertible debt balance (see the amortization table above for details).

(2) Retained earnings at the beginning of the year plus interest expense recognized for the year.

**Upon adoption of ASU 2020-06 on January 1, 20X4**

Under the ASU, due to the elimination of the cash conversion accounting model, FG Corp determined that it should account for the convertible debt as a liability in its entirety (i.e., there is no separation of the conversion feature and all proceeds are allocated to the convertible debt instrument as a single unit of account).

If the ASU had been applied to the debt from the issuance date onwards, FG Corp would have recorded the following journal entry.

*At convertible debt issuance date (January 1, 20X1)*

FG Corp recognizes the cash proceeds from the issuance of convertible debt with a cash conversion option.

|                      |         |         |
|----------------------|---------|---------|
| Dr. Cash             | \$1,000 |         |
| Cr. Convertible debt |         | \$1,000 |

*During 20X1, 20X2, and 20X3*

Annually, FG Corp recognizes the interest payments made during 20X1, 20X2 and 20X3.

|                      |      |      |
|----------------------|------|------|
| Dr. Interest expense | \$20 |      |
| Cr. Cash             |      | \$20 |

*At ASU 2020-06 adoption date on January 1, 20X4*

(1) Modified retrospective transition method

If FG Corp elects the modified retrospective transition method, it should record the following transition adjustment journal entry at the adoption date (i.e., January 1, 20X4).

|  |                      |                      |
|--|----------------------|----------------------|
| Dr. Additional paid-in capital (conversion option) | \$240 <sup>(1)</sup> |                      |
| Cr. Convertible debt discount                      |                      | \$107 <sup>(2)</sup> |
| Cr. Retained earnings                              |                      | \$133 <sup>(3)</sup> |

(1) To derecognize the portion of the proceeds that was separated from the liability component and allocated to equity due to the cash conversion feature.

(2) To derecognize the remaining convertible debt discount balance as of January 1, 20X4 (\$240 discount on debt minus \$133 cumulative amortization of the discount on debt in each of 20X1, 20X2 and 20X3).

(3) To recognize the cumulative adjustment to opening retained earnings as of January 1, 20X4, representing the reversal of the sum of the interest expense in 20X1 (\$41), 20X2 (\$44) and 20X3 (\$48) due to amortization of convertible debt discount under prior GAAP.

The comparative financial statements for 20X2 and 20X3 remain unchanged in the 20X4 financial statements.



(2) Full retrospective transition method

If FG Corp elects the full retrospective transition method, it should record the following transition adjustment journal entry as of the beginning of the first comparative period presented in the 20X4 financial statements (i.e., January 1, 20X2).

|  |                      |                      |
|--|----------------------|----------------------|
| Dr. Additional paid-in capital (conversion option) | \$240 <sup>(1)</sup> |                      |
| Cr. Convertible debt discount                      |                      | \$199 <sup>(2)</sup> |
| Cr. Retained earnings                              |                      | \$41 <sup>(3)</sup>  |

(1) To derecognize the portion of the proceeds that was separated from the liability component and allocated to equity due to the cash conversion feature.

(2) To derecognize the remaining convertible debt discount balance as of January 1, 20X2.

(3) To recognize the cumulative adjustment to opening retained earnings as of January 1, 20X2, representing the reversal of the interest expense in 20X1 due to amortization of convertible debt discount under prior GAAP.

In addition, FG Corp should revise its 20X2 and 20X3 financial statements to reflect the effects of the changes under the ASU. The following table summarizes FG Corp's balance sheet and income statement upon adoption of ASU 2020-06 under the full retrospective transition method.

| After ASU 2020-06                          | January 1,<br>20X2  | December 31,<br>20X2 | December 31,<br>20X3 |
|--|---------------------|----------------------|----------------------|
| <b>Balance sheets</b>                      |                     |                      |                      |
| Cash                                       | \$980               | \$960                | \$940                |
| Total assets                               | <b>980</b>          | <b>960</b>           | <b>940</b>           |
| Convertible debt                           | 1,000               | 1,000                | 1,000                |
| Total liabilities                          | 1,000               | 1,000                | 1,000                |
| Retained earnings                          | (20) <sup>(1)</sup> | (40) <sup>(2)</sup>  | (60) <sup>(2)</sup>  |
| Total stockholders' equity                 | (20)                | (40)                 | (60)                 |
| Total liabilities and stockholders' equity | <b>\$980</b>        | <b>960</b>           | <b>940</b>           |
| <b>Income statements</b>                   |                     |                      |                      |
| Interest expense                           |                     | 20                   | \$20                 |
| Net loss                                   |                     | (\$20)               | (\$20)               |

(1) This amount is the interest expense recognized in FY 20X1. It is calculated as the difference between retained earnings balance as of December 31, 20X1, under prior GAAP (\$61) and the cumulative adjustment to opening retained earnings as of January 1, 20X2 (\$41).

(2) Retained earnings at the beginning of the year plus interest expense recognized for the year.

Based on the above, the reversal of interest expense previously recorded for amortization of debt discount in 20X2 and 20X3 would result in an increase in the net income (or decrease in net loss) for 20X2 and 20X3 by \$44 and \$48, respectively. The statement of changes in equity, statement of cash flows and EPS for the 20X2 and 20X3 comparative reporting periods should be restated accordingly.

### 10.3.1.2 *Transition for convertible instruments with BCF*

The beneficial conversion feature (BCF) accounting model before the adoption of ASU 2020-06 applies to convertible debt and convertible preferred stock with non-detachable conversion features that are "in the money" at the commitment date (typically, the issuance date) and are not separately

accounted for under the derivatives guidance in ASC 815. Under this model, the beneficial conversion feature is recognized by allocating a portion of the proceeds equal to the intrinsic value of the conversion feature to equity (typically, additional paid-in capital) with the remaining proceeds recognized as a liability (if convertible debt) or as equity (if convertible preferred stock). The allocation of intrinsic value to equity creates a discount on the debt or preferred stock. See FG 6.7A (convertible debt) and FG 7.3.2.2A (convertible preferred stock) for further information on convertible instruments with a BCF before adoption of ASU 2020-06.

The elimination of the BCF accounting model results in these instruments being recorded as a single liability (if convertible debt) or a single preferred equity instrument (if preferred stock). As a result, the discount created by recognition of the BCF is eliminated which reduces the amount of interest expense (or the deemed dividend in the case of convertible preferred stock). In the case of convertible debt, adjustments to previously recorded interest expense may impact book/tax differences and deferred tax balances.

Example FG 10-2 illustrates the transition accounting for convertible preferred stock with a BCF.

### EXAMPLE FG 10-2

#### Transition of convertible preferred stock with BCF upon adoption of ASU 2020-06

FG Corp, a calendar year-end public company, adopts ASU 2020-06 on January 1, 20X4. At the adoption date, FG Corp has convertible preferred stock with a BCF along with 100 detachable warrants to purchase common stock outstanding. Information about this instrument is summarized in the following table.

|  |   |
|--|---|
| Convertible preferred stock with detachable warrants commitment date | January 1, 20X1 (this is also the issuance date)              |
| Convertible preferred stock stated value                             | \$1,000   |
| Convertible preferred stock stated conversion price                  | \$20  |
| Number of detachable warrants  | 100 warrants for common stock at a strike price of \$20/share |
| FG Corp's stock price at issuance date                               | \$18/share  |
| Cash proceeds at issuance date                                       | \$1,000   |
| Investor put option  | After 5 years and thereafter                                  |
| Conversion option  | After 4 years and thereafter                                  |

This example ignores the effects of preferred stock issuance costs for simplicity.

What is the appropriate transition adjustment for the convertible preferred stock with a BCF under (1) the modified retrospective method, and (2) the full retrospective method?

*Analysis***Before adoption of ASU 2020-06***At the convertible preferred stock issuance date (January 1, 20X1)*Warrant discount

FG Corp concludes that the convertible preferred stock and the detachable warrants meet the requirements for equity classification.

Since the warrants are classified as equity, FG Corp allocates the proceeds from the issuance of the preferred stock and warrants using the relative fair value method. The proceeds allocated to the convertible preferred stock and warrants are \$700 and \$300, respectively.

FG Corp makes a policy choice to accrete the \$300 discount on convertible preferred stock (recorded as a deemed dividend) as a result of the relative fair value allocation over five years from the issuance date through the first put date (because the preferred stock is puttable by investors at the beginning of year six). FG Corp determines the effective interest rate is 7.39% which is the rate at which the present value of \$1,000 at the end of five years equals the \$700 proceeds allocated to the preferred stock at the issuance date.

The amortization of the warrant discount is shown in the following table.

|  | 20X1                 | 20X2  | 20X3  | 20X4  | 20X5    | Total |
|--|----------------------|-------|-------|-------|---------|-------|
| <b>Preferred stock balance at beginning of period</b>                      | \$700 <sup>(2)</sup> | \$752 | \$808 | \$868 | \$932   |       |
| <b>Amortization of warrant discount (as deemed dividend)<sup>(1)</sup></b> | 52                   | 56    | 60    | 64    | 68      | 300   |
| <b>Preferred stock balance at end of period<sup>(3)</sup></b>              | \$752                | \$808 | \$868 | \$932 | \$1,000 |       |

(1) Preferred stock balance at the beginning of the period multiplied by the effective interest rate of 7.39%.

(2) Amount of proceeds allocated to preferred stock at the issuance date.

(3) Preferred stock balance at the beginning of the period plus deemed dividend due to amortization of the warrant discount.

Beneficial conversion feature

Based on a stated conversion price of \$20, the preferred stock is convertible into 50 shares of FG Corp's common stock (\$1,000 stated value / \$20 conversion price).

The effective conversion price is \$14 calculated by dividing (1) the proceeds received for the convertible preferred stock (\$700) by (2) the number of common shares into which the preferred stock is convertible (50 shares).

$$\$700 / 50 \text{ shares} = \$14 \text{ conversion price}$$

FG Corp determines the convertible preferred stock contains a BCF as its stock price of \$18 on the issuance date is greater than the \$14 effective conversion price. The BCF calculated is \$200, representing the difference between the issuance date stock price (\$18) and the effective conversion price (\$14) multiplied by the number of shares into which the preferred stock is convertible (50 shares).

The amount of the proceeds allocated to preferred stock is therefore \$500 (the difference between the \$700 proceeds allocated to the preferred stock and \$200 BCF equity component).

FG Corp makes a policy choice to accrete the BCF discount of \$200 (i.e., record accretion as a deemed dividend) over four years from the issuance date through the first conversion date because the preferred stock is convertible by investors at the beginning of year five and is not puttable until the beginning of year six. FG Corp determines the effective interest rate is 8.78% which is the rate at which the present value of \$700 at the end of four years equals the \$500 proceeds allocated to the preferred stock at the issuance date.

The amortization of the BCF is shown in the following table.

|   | 20X1                 | 20X2  | 20X3  | 20X4  | Total |
|---|----------------------|-------|-------|-------|-------|
| <b>Preferred stock balance at beginning of period</b>         | \$500 <sup>(2)</sup> | \$544 | \$592 | \$644 |       |
| <b>Amortization of BCF (as deemed dividend)<sup>(1)</sup></b> | 44                   | 48    | 52    | 56    | 200   |
| <b>Preferred stock balance at end of period<sup>(3)</sup></b> | \$544                | \$592 | \$644 | \$700 |       |

(1) Preferred stock balance at the beginning of the period multiplied by the effective interest rate of 8.78%.

(2) Amount of proceeds allocated to preferred stock.

(3) Preferred stock balance at the beginning of the period plus deemed dividend due to amortization of the BCF.

FG Corp records the following journal entry on January 1, 20X1 to recognize the receipt of cash proceeds from the issuance of convertible preferred stock with warrants and the separation of the instrument into preferred stock, warrants and the BCF.

|  |         |         |
|--|---------|---------|
| Dr. Cash   | \$1,000 |         |
| Dr. Discount on convertible preferred stock (relative fair value allocation) | \$300   |         |
| Dr. Discount on convertible preferred stock (BCF)                            | \$200   |         |
| Cr. Convertible preferred stock  |         | \$1,000 |
| Cr. Additional paid-in capital (warrants)                                    |         | \$300   |
| Cr. Additional paid-in capital (BCF)   |         | \$200   |

*During the first year (20X1)*

FG Corp records the following journal entry to recognize the amortization of the warrant and BCF discount as deemed dividends.

|  |      |      |
|--|------|------|
| Dr. Retained earnings  | \$96 |      |
| Cr. Discount on convertible preferred stock (relative fair value allocation) |      | \$52 |
| Cr. Discount on convertible preferred stock (BCF)                            |      | \$44 |

*During the second year (20X2)*

FG Corp records the following journal entry to recognize the amortization of the warrant and BCF discount as deemed dividends.

|  |       |      |
|--|-------|------|
| Dr. Retained earnings  | \$104 |      |
| Cr. Discount on convertible preferred stock (relative fair value allocation) |       | \$56 |
| Cr. Discount on convertible preferred stock (BCF)                            |       | \$48 |

*During the third year (20X3)*

FG Corp records the following journal entry to recognize the amortization of the warrant and BCF discount as deemed dividends.

|  |       |      |
|--|-------|------|
| Dr. Retained earnings  | \$112 |      |
| Cr. Discount on convertible preferred stock (relative fair value allocation) |       | \$60 |
| Cr. Discount on convertible preferred stock (BCF)                            |       | \$52 |

The following table summarizes FG Corp's balance sheet as of December 31, 20X1, 20X2, 20X3 (assume the convertible preferred stock with the BCF and 100 detachable warrants is FG Corp's only contract):

| Before ASU 2020-06                          | Year ended December 31 |                      |                      |
|---|------------------------|----------------------|----------------------|
|   | 20X1                   | 20X2                 | 20X3                 |
| Cash  | \$1,000                | \$1,000              | \$1,000              |
| Total assets                                | <b>1,000</b>           | <b>1,000</b>         | <b>1,000</b>         |
| Convertible preferred stock                 | 1,000                  | 1,000                | 1,000                |
| Discount on convertible preferred stock     | (404) <sup>(1)</sup>   | (300) <sup>(1)</sup> | (188) <sup>(1)</sup> |
| Additional paid-in capital (BCF + warrants) | 500                    | 500                  | 500                  |
| Retained earnings                           | (96) <sup>(2)</sup>    | (200) <sup>(2)</sup> | (312) <sup>(2)</sup> |
| Total stockholders' equity                  | <b>\$1,000</b>         | <b>\$1,000</b>       | <b>\$1,000</b>       |

(1) Remaining balance of unamortized preferred stock discount attributable to warrants and BCF (\$500 total discount minus the sum of cumulative amortization of BCF and warrants discount). See amortization tables above for discount on preferred stock due to warrants and BCF for details.

(2) Retained earnings at the beginning of the year plus deemed dividends due to amortization of discount recognized for the year.

**Upon adoption of ASU 2020-06 on January 1, 20X4**

The convertible preferred stock is accounted for as a single mezzanine classified instrument due to the elimination of the BCF accounting model. At the issuance date, \$700 is allocated to the convertible preferred stock as a single unit of account.

Had the ASU been applied to the convertible preferred stock at the issuance date, FG Corp would have recorded the following journal entries.

*At convertible preferred stock issuance date (January 1, 20X1)*

Recognize the cash proceeds from the issuance of convertible preferred stock with detachable common stock warrants.

|  |         |         |
|--|---------|---------|
| Dr. Cash   | \$1,000 |         |
| Dr. Discount on convertible preferred stock (relative fair value allocation) | \$300   |         |
| Cr. Convertible preferred stock  |         | \$1,000 |
| Cr. Additional paid-in capital (warrants)                                    |         | \$300   |

*During 20X1, 20X2, and 20X3*

Recognize the amortization of the warrant discount as a deemed dividend as follows:

*During 20X1*

|   |      |      |
|---|------|------|
| Dr. Retained earnings                       | \$52 |      |
| Cr. Discount on convertible preferred stock |      | \$52 |

*During 20X2*

|   |      |      |
|---|------|------|
| Dr. Retained earnings                       | \$56 |      |
| Cr. Discount on convertible preferred stock |      | \$56 |

*During 20X3*

|   |      |      |
|---|------|------|
| Dr. Retained earnings                       | \$60 |      |
| Cr. Discount on convertible preferred stock |      | \$60 |

*At ASU 2020-06 adoption date on January 1, 20X4*

**(1) Modified retrospective method**

If FG Corp elects the modified retrospective transition method, it should record the following transition adjustment journal entry at the adoption date (i.e., January 1, 20X4).

|   |                      |                      |
|---|----------------------|----------------------|
| Dr. Additional paid-in capital (BCF)              | \$200 <sup>(1)</sup> |                      |
| Cr. Discount on convertible preferred stock (BCF) |                      | \$56 <sup>(2)</sup>  |
| Cr. Retained earnings                             |                      | \$144 <sup>(3)</sup> |

(1) To derecognize the portion of the proceeds that was allocated to the BCF.

(2) To derecognize the remaining discount attributable to the BCF as of January 1, 20X4 (\$200 BCF minus \$144 cumulative amortization of the BCF in 20X1, 20X2 and 20X3).

(3) To recognize the cumulative adjustment to opening retained earnings as of January 1, 20X4 representing the reversal of the sum of the deemed dividends in 20X1 (\$44), 20X2(\$48) and 20X3(\$52) due to the amortization of the BCF under prior GAAP.

The comparative financial statements for 20X2 and 20X3 remain unchanged in the 20X4 financial statements.

## (2) Full retrospective method

If FG Corp elects the full retrospective transition method, it should record the following transition adjustment as of the beginning of the first comparative period presented in the 20X4 financial statements (i.e., January 1, 20X2).

|   |                      |                      |
|---|----------------------|----------------------|
| Dr. Additional paid-in capital (BCF)              | \$200 <sup>(1)</sup> |                      |
| Cr. Discount on convertible preferred stock (BCF) |                      | \$156 <sup>(2)</sup> |
| Cr. Retained earnings                             |                      | \$44 <sup>(3)</sup>  |

(1) To derecognize the portion of the proceeds that was allocated to the BCF.

(2) To derecognize the remaining discount attributable to the BCF as of January 1, 20X2.

(3) To recognize the cumulative adjustment to opening retained earnings as of January 1, 20X2 representing the reversal of the deemed dividend in 20X1 due to the amortization of the BCF under prior GAAP.

In addition, FG Corp should revise its 20X2 and 20X3 financial statements to reflect the effects of the changes under the ASU. The following table summarizes FG Corp's balance sheet upon adoption of ASU 2020-06 under the full retrospective transition method.

| After ASU 2020-06                       | January 1,<br>20X2  | December 31,<br>20X2 | December 31,<br>20X3 |
|---|---------------------|----------------------|----------------------|
| Cash                                    | \$1,000             | \$1,000              | \$1,000              |
| Total assets                            | <u>1,000</u>        | <u>1,000</u>         | <u>1,000</u>         |
| Convertible preferred stock             | 1,000               | 1,000                | 1,000                |
| Discount on convertible preferred stock | (248)               | (192)                | (132)                |
| Additional paid-in capital (warrants)   | 300                 | 300                  | 300                  |
| Retained earnings                       | (52) <sup>(1)</sup> | (108) <sup>(2)</sup> | (168) <sup>(2)</sup> |
| Total stockholders' equity              | <u>\$1,000</u>      | <u>\$1,000</u>       | <u>\$1,000</u>       |

(1) Difference between the retained earnings balance as of December 31, 20X1 under the prior GAAP (\$96) and the cumulative adjustment to opening retained earnings as of January 1, 20X2 (\$44).

(2) Retained earnings at the beginning of the year plus deemed dividend recognized for the year.

Based on the above, the reversal of the deemed dividends recorded for the amortization of the BCF in 20X2 and 20X3 would result in an increase to the numerator in basic EPS for 20X2 and 20X3 of \$48 and \$52, respectively. The statements of changes in equity for 20X2 and 20X3 should be restated accordingly.

### **10.3.2 Transition for equity-linked instruments**

Freestanding equity linked instruments must be analyzed pursuant to ASC 815-40 in order to determine whether they should be classified as equity, or an asset or liability. Similarly, embedded equity-linked features that are not clearly and closely related to their host instrument must be analyzed pursuant to ASC 815-40 in order to determine whether they must be bifurcated from their host and separately accounted for as liabilities. ASC 815-40-25 includes numerous conditions that must be met in order to conclude that these freestanding equity-linked instruments and equity-linked embedded features can be classified as equity. ASU 2020-06 eliminates three of these conditions in ASC 815-40-25-10A. The three conditions that no longer need to be considered are (1) whether settlement is required in registered shares, (2) whether counterparty rights rank higher than shareholder rights, and (3) whether collateral is required.

#### **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. Equity-linked instruments model 5-34
- 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 Exchanges 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.



**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.

**10.3.2.1 Transition of certain equity-linked instruments**

Prior to the adoption of ASU 2020-06, reporting entities may have classified a freestanding equity-linked instrument (or an embedded equity-linked feature) as a liability based on an evaluation of one of the three eliminated conditions mentioned in FG 10.3.2. For example, if a warrant required the delivery of registered shares upon exercise, a reporting entity would have been required to classify the warrant as a liability.

Upon adoption of ASU 2020-06, the three conditions described in ASC 815-40-25-10A would no longer require a freestanding contract or embedded feature be classified as a liability. As a result, the changes in fair value of the liability would no longer need to be recognized in the income statement, and a transition adjustment would be required for these instruments. Furthermore, for certain instruments with an embedded equity linked feature such as nonconvertible debt with warrants, the change in the classification of the warrants from a liability to equity would impact the discount on the debt and hence interest expense. The change in interest expense may also impact capitalized interest as discussed in Question FG 10-1. Changes in the income statement due to changes in fair value of the liability or interest expense previously recognized for financial reporting purposes may impact book/tax differences and deferred tax balances.

See FG 5.6.3 (post adoption of ASU 2020-06) and FG 5.6.3A (pre adoption of ASU 2020-06) for further information on the equity classification requirements for equity-linked instruments.

Example FG 10-3 illustrates the transition of a liability classified warrant that would be equity classified upon adoption of ASU 2020-06.

**EXAMPLE FG 10-3****Transition of a liability classified warrant that would be equity classified upon adoption of ASU 2020-06**

FG Corp, a calendar year-end public company, adopts ASU 2020-06 on January 1, 20X4. At the adoption date, FG Corp has preferred stock with detachable common stock warrants outstanding. Information about this instrument is summarized in the following table.

|   |   |       |       |       |
|---|---|-------|-------|-------|
| Preferred stock with detachable common stock warrants issuance date | January 1, 20X1   |       |       |       |
| Preferred stock stated value  | \$1,000   |       |       |       |
| Common stock detachable warrants                                    | 100 detachable warrants to buy common stock   |       |       |       |
| Preferred stock features  | No conversion feature; contains a contingent redemption feature that is not probable of becoming redeemable |       |       |       |
| Cash proceeds at issuance date                                      | \$1,000   |       |       |       |
| Certain provisions  | The warrant requires the delivery of registered shares  |       |       |       |
| Fair value of preferred stock at issuance date                      | \$710   |       |       |       |
| Warrant fair value and change in fair value                         |   | 20X1  | 20X2  | 20X3  |
|   | Fair value at beginning of period   | \$300 | \$340 | \$310 |
|   | Change in fair value  | 40    | (30)  | 50    |
|   | Fair value at end of period   | \$340 | \$310 | \$360 |

This example ignores the effects of issuance costs and income taxes for simplicity.

What is the appropriate transition adjustment for the detachable common stock warrants outstanding at the ASU 2020-06 adoption date under (1) the modified retrospective method, and (2) the full retrospective method?

*Analysis***Before adoption of ASU 2020-06**

*At instrument issuance date (January 1, 20X1)*

FG Corp concludes the warrant does not meet the requirements for equity classification because the warrant requires the delivery of registered shares.

Since the warrants are classified as a liability, FG Corp first allocates some of the proceeds to the warrant based on its fair value at issuance date (\$300) with the remaining proceeds (\$700 = \$1,000 - \$300) allocated to the preferred stock.

FG Corp records the following journal entry on January 1, 20X1 to recognize the receipt of cash proceeds from the issuance of preferred stock with detachable common stock warrants.

|  |         |         |
|--|---------|---------|
| Dr. Cash   | \$1,000 |         |
| Dr. Discount on preferred stock (resulting from consideration allocated to warrants) | \$300   |         |
| Cr. Warrant liability  |         | \$300   |
| Cr. Preferred stock  |         | \$1,000 |

*During the first year (20X1)*

FG Corp records the following journal entry to recognize a loss due to the increase in the fair value of the warrants.

|                       |      |      |
|-----------------------|------|------|
| Dr. Loss from warrant | \$40 |      |
| Cr. Warrant liability |      | \$40 |

*During the second year (20X2)*

FG Corp records the following journal entry to recognize a gain due to the decrease in the fair value of the warrants.

|                       |      |      |
|-----------------------|------|------|
| Dr. Warrant liability | \$30 |      |
| Cr. Gain from warrant |      | \$30 |

*Fair value change during the third year (20X3)*

FG Corp records the following journal entry to recognize a loss due to the increase in the fair value of the warrants.

|                       |      |      |
|-----------------------|------|------|
| Dr. Loss from warrant | \$50 |      |
| Cr. Warrant liability |      | \$50 |

The following table summarizes FG Corp's balance sheet and income statement as of and for the years ended December 31, 20X1, 20X2, 20X3, respectively (assume that the preferred stock with detachable common stock warrants is FG Corp's only contract).

**Before ASU 2020-06**

|  | 20X1                | 20X2                | 20X3                |
|--|---------------------|---------------------|---------------------|
| <b>Balance sheets</b>                      |                     |                     |                     |
| Cash                                       | \$1,000             | \$1,000             | \$1,000             |
| Total assets                               | <u>1,000</u>        | <u>1,000</u>        | <u>1,000</u>        |
| Warrant liability                          | 340                 | 310                 | 360                 |
| Total liabilities                          | 340                 | 310                 | 360                 |
| Convertible preferred stock, net           | 700                 | 700                 | 700                 |
| Retained earnings                          | (40) <sup>(1)</sup> | (10) <sup>(1)</sup> | (60) <sup>(1)</sup> |
| Total stockholders' equity                 | 660                 | 690                 | 640                 |
| Total liabilities and stockholders' equity | <u>1,000</u>        | <u>1,000</u>        | <u>1,000</u>        |
| <b>Income statements</b>                   |                     |                     |                     |
| Gain (loss) from warrant                   | (40)                | 30                  | (50)                |
| Net income (loss)                          | <u>(\$40)</u>       | <u>\$30</u>         | <u>(\$50)</u>       |

(1) Retained earnings at the beginning of the year plus gain (loss) from change in fair value of the warrant recognized for the year.

**Upon adoption of ASU 2020-06 on January 1, 20X4**

Pursuant to ASC 815-40-25-10A(a), a provision requiring the delivery of registered shares does not preclude equity classification unless the contract explicitly states that the contract must be settled in cash if registered shares are not available. FG Corp's contract does not explicitly state that the warrant must be settled in cash. As there are no other provisions in the warrant agreement that would require liability classification, FG Corp would have concluded that the warrants are equity classified under ASU 2020-06.

Had the ASU been applied to the warrants at the issuance date, FG Corp would have recorded the following journal entries.

*At the issuance date (January 1, 20X1)*

Since the warrants are classified as equity, FG Corp would have allocated the \$1,000 proceeds from the issuance of the preferred stock and warrants using the relative fair value method based on the \$710 fair value of the preferred stock and the \$300 fair value of the warrants at the date of issuance. The allocation would have been as follows:

$$\$1,000 \times \$710 / (\$710 + \$300) = \$703 \text{ proceeds allocated to preferred stock}$$

$$\$1,000 \times \$300 / (\$710 + \$300) = \$297 \text{ proceeds allocated to warrants}$$

FG Corp would have recorded the following journal entry to recognize the receipt of cash proceeds from the issuance of the preferred stock with detachable common stock warrants.

|   |         |         |
|---|---------|---------|
| Dr. Cash  | \$1,000 |         |
| Dr. Discount on preferred stock (resulting from relative fair value allocation) | \$297   |         |
| Cr. Additional paid-in capital (warrants)                                       |         | \$297   |
| Cr. Preferred stock   |         | \$1,000 |

*During 20X1, 20X2 and 20X3*

As the warrants would have been equity classified, FG Corp would not have recognized the change in fair value of the warrants through earnings during 20X1, 20X2 and 20X3.

*At ASU 2020-06 adoption date on January 1, 20X4*

(1) Modified retrospective method

If FG Corp elects the modified retrospective transition method, it should record the following transition adjustment at the adoption date (i.e., January 1, 20X4).

|   |                      |                      |
|---|----------------------|----------------------|
| Dr. Warrant liability                     | \$360 <sup>(1)</sup> |                      |
| Cr. Discount on preferred stock           |                      | \$3 <sup>(2)</sup>   |
| Cr. Additional paid-in capital (warrants) |                      | \$297 <sup>(3)</sup> |
| Cr. Retained earnings                     |                      | \$60 <sup>(4)</sup>  |

(1) To reclassify the warrant liability at January 1, 20X4 to equity.

(2) To adjust the discount on the preferred stock based on the relative fair value method of allocation of proceeds

(3) To reflect difference between the relative fair value allocation method as a result of the adoption compared to the residual allocation under prior accounting.

(4) To recognize the cumulative adjustment to opening retained earnings as of January 1, 20X4 representing the reversal of the cumulative income statement impact due to the change in the fair value of the warrants under prior GAAP.

The financial statements for 20X2 and 20X3 remain unchanged.

(2) Full retrospective method

If FG Corp elects the full retrospective transition method, it should record the following transition adjustment as of the beginning of the first comparative reporting period presented in the 20X4 financial statements (i.e., January 1, 20X2).

|   |                      |                      |
|---|----------------------|----------------------|
| Dr. Warrant liability                     | \$340 <sup>(1)</sup> |                      |
| Cr. Discount on preferred stock           |                      | \$3 <sup>(2)</sup>   |
| Cr. Additional paid-in capital (warrants) |                      | \$297 <sup>(3)</sup> |
| Cr. Retained earnings                     |                      | \$40 <sup>(4)</sup>  |

(1) To reclassify the warrant liability at January 1, 20X2 to equity.

(2) To reflect the difference between the relative fair value allocation method as a result of the adoption compared to the residual allocation under prior accounting

(2) To record the warrant in equity based on a relative fair value allocation.

(3) To recognize the cumulative adjustment to opening retained earnings as of January 1, 20X2 representing the reversal of the cumulative income statement impact due to the change in the fair value of the warrant under prior GAAP.

In addition, FG Corp would revise its comparative 20X2 and 20X3 financial statements in its 20X4 financial statements to reflect the effects of the changes pursuant to ASU 2020-06. The following table

summarizes FG Corp's balance sheet and income statement upon adoption of ASU 2020-06 under the full retrospective transition method.

| <b>After ASU 2020-06</b>                   | <b>January 1,<br/>20X2</b> | <b>December 31,<br/>20X2</b> | <b>December 31,<br/>20X3</b> |
|--|----------------------------|------------------------------|------------------------------|
| <b>Balance sheets</b>                      |                            |                              |                              |
| Cash                                       | \$1,000                    | \$1,000                      | \$1,000                      |
| Total assets                               | <b>1,000</b>               | <b>1,000</b>                 | <b>1,000</b>                 |
| Convertible preferred stock, net           | 703                        | 703                          | 703                          |
| Additional paid-in capital (warrants)      | 297                        | 297                          | 297                          |
| Retained earnings                          | 0 <sup>(1)</sup>           | 0                            | 0                            |
| Total stockholders' equity                 | 1,000                      | 1,000                        | 1,000                        |
| Total liabilities and stockholders' equity | <b>\$1,000</b>             | <b>1,000</b>                 | <b>1,000</b>                 |
| <b>Income statements</b>                   |                            |                              |                              |
| Net income (loss)                          |                            | <b>\$0</b>                   | <b>\$0</b>                   |

(1) Difference between the retained earnings balance as of December 31, 20X1 under the prior GAAP (\$40) and the cumulative adjustment to opening retained earnings as of January 1, 20X2 (\$40).

Based on the above, the gain or loss due to a change in the fair value of the warrant in 20X2 and 20X3 would get reversed after adopting the ASU. The net income for 20X2 would decrease by \$30, and the net income for 20X3 would increase by \$50. The statements of changes in equity, statements of cash flows and EPS for 20X2 and 20X3 comparative reporting periods should be restated accordingly.

The basis for conclusions of the ASU summarizes the impact of the guidance to certain equity-linked instruments upon adoption of ASU 2020-06.

#### **ASU 2020-06 BC129**

The following table includes examples of how the transition method(s) should be applied in common scenarios:

| <b>Instrument Type and Current GAAP Classification</b>                                    | <b>Effect of Guidance (If Scope Exception Currently Failed, but Passed under the Amendments)</b>  |
|---|---|
| Freestanding instrument is classified as a liability.                                     | Reclassify to equity and adjust basis of instrument to what would have been the value at initial measurement.   |
| Embedded feature is classified as a liability, and the host is classified as a liability. | Recombine instruments into a single liability instrument. Determine what the basis of that instrument would have been originally if the embedded feature had not been bifurcated.<br><br>This would include a recalculation of the effective interest rate and any amortization of a discount (or premium). |

**ASU 2020-06 BC129**

The following table includes examples of how the transition method(s) should be applied in common scenarios:

| <b>Instrument Type and Current GAAP Classification</b>   | <b>Effect of Guidance (If Scope Exception Currently Failed, but Passed under the Amendments)</b>  |
|--|---|
| Embedded feature is classified as a liability, and the host is classified as equity.                                       | Recombine instruments into a single equity instrument and recalculate basis. Determine what the basis of that instrument would have been originally if the embedded feature had not been bifurcated.  |
| Multiple embedded features are bifurcated from the host and classified as liabilities (host is classified as equity).      | Recombine instruments into a single equity instrument (except for features not affected by this guidance) and recalculate basis. Determine what the basis of that instrument would have been originally if the embedded feature(s) had not been bifurcated.   |
| Multiple embedded features are bifurcated from the host and classified as liabilities (host is classified as a liability). | Recombine instruments into a single liability instrument (except for features not affected by this guidance) and recalculate basis. Determine what the basis of that instrument would have been originally if those embedded features had not been bifurcated. This would include a recalculation of the effective interest rate and any amortization of a discount (or premium). |
| Debt is issued with detachable warrants.   | Recalculate Day 1 allocation between the debt and warrants. Reclassify the warrants to equity on the basis of original relative fair value. Recalculate the basis of the debt. This would include a recalculation of the effective interest rate and any amortization of a discount (or premium).   |

**ASU 2020-06 BC130**

The effects of the basis adjustments described in the table above would be recognized in accordance with the transition requirements in paragraph 815-40-65-1(b).

## **10.4 Other considerations**

Question FG 10-1 and Question FG 10-2 discuss the impact of ASU 2020-06 on capitalized interest.

**Question FG 10-1**

A reporting entity issued a convertible bond with an embedded conversion option. The embedded conversion option was accounted for in equity under prior GAAP and created a debt discount. The reporting entity capitalized the interest cost as part of its historical cost of acquiring certain assets under ASC 835-20. Under the new guidance, the instrument is required to be accounted for as traditional convertible debt (i.e., no separate accounting of the conversion option).

Should the reporting entity consider the effects of the changes in interest expense on the amount of capitalized interest costs as a result of adopting ASU 2020-06?

***PwC response***

Yes. If as a result of the adoption of ASU 2020-06, the change in the amount of interest accrued on these instruments changes, then the resulting impact and effect on the amount capitalized must also be reflected.

It is important to note that the effect may be different depending on the method of adoption. For example, under the modified retrospective method, the effect of adoption would only apply to those instruments that are outstanding at the date of adoption, whereas under the full retrospective method, it would apply to all historical debt instruments within the scope of the ASU.

**Question FG 10-2**

A reporting entity issued debt with warrants that were recognized at fair value and classified as a liability under prior GAAP. The reporting entity capitalized the interest cost as part of its historical cost of acquiring certain assets under ASC 835-20. Under the new guidance, the warrants qualify for equity treatment. This change in classification of warrants from liability to equity would result in changing the method of allocating consideration from the residual method of allocation (i.e., allocate consideration to warrants based on their fair value and remaining consideration to the debt) to a relative fair value allocation method. As a result, the debt discount and resulting interest expense may change.

Should the reporting entity consider the effects of the changes in interest expense on the amount of capitalized interest costs as a result of adopting ASU 2020-06?

***PwC response***

Yes. If as a result of the adoption of ASU 2020-06, the change in the amount of interest accrued on these instruments changes, then the resulting impact and effect on the amount capitalized must also be reflected.

It is important to note that the effect may be different depending on the method of adoption. For example, under the modified retrospective method, the effect of adoption would only apply to those instruments that are outstanding at the date of adoption, whereas under the full retrospective method, it would apply to all historical debt instruments within the scope of the ASU.



## **10.5 Transition disclosure requirements**

ASU 2020-06 requires reporting entities to include the following transition disclosures in the period of adoption for both interim (if applicable) and annual reporting:

- The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle
- The method of applying the change
- The cumulative effect of the change on retained earnings or other components of equity in the balance sheet as of the beginning of the first period for which the ASU is initially applied
- For reporting entities that present earnings per share, the effect of the change on affected per-share amounts for the period of adoption

If reporting entities elect the full retrospective method for transition, the following disclosure is also required:

- The effect of the change on income from continuing operations, net income, any other affected financial statement line item and any affected per-share amounts for the current period and any prior periods retrospectively adjusted.