In depth

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Adopting the new liability and equity guidance early

What's inside

At a glance

A number of reporting entities are considering early adoption of the FASB's most recent guidance on liabilities and equity. To do so, calendar year-end SEC filers will need to adopt as of January 1, 2021. This *In depth* highlights key points to consider and potentially unexpected consequences of adopting and summarizes the standard's transition provisions.

For details on the changes to GAAP introduced by the new guidance, refer to In depth 2020-07, *Accounting for convertible instruments and own equity contracts* and our *Financing* guide.

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), Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. ASU 2020-06 simplifies the accounting for certain financial instruments with characteristics of liabilities and equity by reducing the number of accounting models for convertible debt and convertible preferred stock instruments. In addition, the FASB amended the derivative guidance for the "own stock" scope exception and certain aspects of ASC 260, Earnings per Share.

ASU 2020-06 is effective for calendar year-end SEC filers (other than smaller reporting companies as defined by the SEC) for fiscal years beginning after December 15, 2021 (including interim periods within those fiscal years). Early adoption is permitted for fiscal years beginning after December 15, 2020 (including interim periods), but only if adopted as of the beginning of the fiscal year. As a result, calendar year reporting entities considering early adoption must do so as of January 1, 2021.

Adoption of ASU 2020-06 may have unexpected consequences related to how certain instruments are reflected on a reporting entity's balance sheet and treated in the computation of earnings per share. This *In depth* summarizes some of the key considerations a reporting entity should evaluate before electing to early adopt the standard.

Mezzanine equity reporting considerations

Prior to the adoption of ASU 2020-06, in most instances, if an instrument indexed to an entity's own stock could require cash settlement outside of the entity's control, ASC 815-40 required the instrument (or an embedded derivative) to be reported as an asset or liability. ASU 2020-06 provides exceptions such that the three conditions in ASC 815-40-25-10A do not need to be considered in evaluating settlement provisions for instruments indexed to an entity's own stock.

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

SEC reporting entities are subject to the guidance in ASC 480-10-S99, which is also applied by many non-SEC reporting entities. Under this guidance, instruments that are redeemable for cash or other assets outside of the reporting entity's control must be classified as mezzanine equity.

ASU 2020-06 did not amend the guidance in ASC 480-10-S99. As a result, the three features that do not need to be evaluated when determining the appropriate presentation under ASC 815, still need to be considered to determine if the instrument needs to be classified as mezzanine equity. Classification as mezzanine equity can impact:

- presentation of the instrument on the balance sheet,
- subsequent remeasurement of the instrument, and
- earnings per share.

Reporting entities seeking to avoid classification as mezzanine equity by applying the exceptions to the evaluation of net cash settlement provided by the new guidance to the evaluation under ASC 480-10-S99 (i.e., by analogizing to the guidance in ASC 815-40-25-10A), should pre-clear their proposed accounting and disclosures with the Office of the Chief Accountant of the SEC.

No analogy to exceptions in ASC 815-40

The exceptions provided in ASC 815-40-25-10A are only applicable to the specific features listed. We do not believe that it would be appropriate to analogize to these exceptions. For example, derivative instruments are frequently transacted under master netting arrangements, which provide that in the event of default of one of the counterparties, all derivative instruments are net settled through a single cash payment. As a result, these instruments can be cash settled outside of the control of the reporting entity. An instrument subject to a master netting arrangement that permits net settlement of instruments indexed to an entity's own stock with instruments that are classified as assets and liabilities would not qualify for one of the exceptions in ASC 815-40-25-10A and would not be eligible for equity classification.

Evaluation of existing instruments

Reporting entities evaluating certain instruments indexed to their own stock may have evaluated an instrument by only looking for certain provisions and, if those provisions existed (or did not exist), classified the instrument (or embedded derivative) as a liability. Once equity classification was precluded, they may not have reviewed the rest of the agreement for other potential triggers when evaluating the guidance in ASC 815-40. For example, if a warrant did not have a provision that would permit the delivery of unregistered shares and did not have a provision indicating an entity could not be required to cash settle the instrument, a reporting entity may have concluded the warrant was liability classified without reviewing the rest of the provisions.

Upon adoption of ASU 2020-06, while the specific provision that required an instrument to be reported as a liability (or bifurcated from a host instrument) may no longer need to be considered, the reporting entity will need to evaluate the rest of the agreement to determine if there are other features not previously evaluated that may require the instrument to continue to be classified as a liability (e.g., insufficient authorized but unissued shares). In addition, those other features may impact the analysis under ASC 480-10-S99 (i.e., mezzanine equity analysis). Determining the appropriate classification will require a detailed analysis of the terms of the agreement and potentially the views of legal counsel.

Expanded disclosure requirements

The FASB concluded that the existing disclosure requirements for convertible instruments and contracts in an entity's own equity did not need substantial revision. However, the Board expects disclosures to provide financial statement users with (a) information about the terms and features of the instrument, (b) an understanding of how instruments have been reported in the statement of financial position and statement of financial performance, and (c) information about events, conditions, and circumstances that can affect the amount or timing of future cash flows.

As a result, ASU 2020-06 creates some additional disclosure requirements which are further discussed in FG 5.8, FG 6.11 (for convertible debt), and FG 7.11 (for preferred instruments).

Other considerations

ASU 2020-06's elimination of the beneficial conversion and cash conversion guidance will result in "recombining" the equity and debt components of certain convertible debt instruments into a single liability. As a result, some or all of the discount on the liability created by recognition of a component of the convertible debt in equity will be eliminated. This will reduce the amount of interest expense on the instrument. While many reporting entities may find this to be attractive, other implications should be considered, which may vary depending on the method of adoption:

- Capitalized interest: Some entities use convertible instruments to finance assets while they are getting ready for use and capitalize interest cost in accordance with ASC 835-20. The change in the amount of interest accrued on these instruments will change the amount eligible to be capitalized.
- Covenants and financial ratios: Some financial ratios, such as the ratio of debt to equity, will change if amounts are reclassified from equity to a liability. For example, recombining a convertible debt instrument that was separated between liabilities and equity under the cash conversion guidance will reduce equity and increase liabilities. Reporting entities should consider any impacts on debt covenants and other similar arrangements.
- Conversion vs. extinguishment: The change to the guidance on convertible instruments may also change when settlements are considered conversions vs. extinguishments. The changes also impact the analysis of whether a transaction is considered an induced conversion or an extinguishment. This could impact the treatment of prior transactions if, for example, a reporting entity elects the retrospective method of adoption as well as impact transactions following adoption.
- Taxes: Changes in the interest expense recognized for financial reporting purposes may impact book/tax differences and deferred tax balances.
- Diluted EPS: 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 some instruments for which the reporting entity is asserting cash settlement, the adoption of the standard may reduce diluted EPS.

Effective date and transition

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. 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 ASU requires adoption using one of the following two methods:

- Modified retrospective basis 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. EPS amounts are not restated in prior periods presented. For calendar year companies early adopting the standard, this cumulative effect of adoption would be recognized on 1/1/2021.
- Retrospective basis to financial instruments outstanding as of the beginning of the first comparative reporting period for each prior reporting period presented in accordance with the guidance on

accounting changes in ASC 250. Under this method, EPS for all prior periods should be restated.

Although on potentially different populations and as of different dates, both methods require a reporting entity to calculate the impact of adopting the standard as if they had been applying the ASU since the affected instruments were issued. This could require a significant amount of effort.

Both methods of adoption require a reporting entity to evaluate all instruments outstanding at a point in time:

- the date of adoption (1/1/2021 for calendar year companies that elect early adoption) if a company elects the modified retrospective basis or
- the beginning of the first comparative reporting period if a company elects the retrospective basis.

A reporting entity can not elect to early adopt the guidance only for selected instruments, it must be adopted on an entity wide basis with one exception related to companies that have not adopted ASU 2017-11 which included amendments related to down round features.

The ASU also allows an 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 liability classified convertible securities that would, as a result of adopting ASU 2020-06, be 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 an entity adopted ASU 2020-06.

Within the basis for conclusions of ASU 2020-06, the FASB provided a summary of the impact of the guidance to certain instruments upon adoption of ASU 2020-06.

BC129. The following table includes examples of how the transition method(s) should be applied in common scenarios:

Instrument Type and Current GAAP Classification	**Effect of Guidance (If Scope Exception Currently Failed, but Passed under the Amendments)**
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. This would include a recalculation of the effective interest rate and any amortization of a discount (or premium).

Instrument Type and Current GAAP Classification	Effect of Guidance (If Scope Exception Currently Failed, but Passed under the Amendments)
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)

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).

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