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Accounting for Convertible Instruments – Refresher for Private Companies

Determining proper classification can be complicated for financial instruments that have characteristics of both debt and equity, *i.e.*, convertible debt. In 2020, FASB issued Accounting Standards Update (ASU) 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*, which made targeted changes to the guidance on convertible instruments and the derivative scope exception for contracts in an entity's own equity. The standard includes several new disclosures for convertibles and earnings per share (EPS) calculations. Here's a refresher on the soon-to-be-effective rule.

Effective Dates ASU 2020-06	**SEC Filers, Not SRCs** **Already Effective**	**All Others** Annual & interim periods beginning after December 15, 2023

Convertible Instruments

Previous to the issuance of ASU 2020-06, there were five accounting models for convertible debt instruments; four of the models require that a convertible debt instrument be separated (using different separation approaches) into a debt component and an equity or a derivative component. Convertible preferred stock also is required to be assessed under similar models.

ASU 2020-06 reduces the number of accounting models available for convertible debt securities from five to two, and for convertible preferred stock from four to three, which would result in fewer embedded conversion features being separately recognized from the host contract. Eliminated models include:

- Cash conversion – Under this model, the host contract is measured at the fair value of a similar debt without a conversion feature and conversion features are recorded as equity components at the residual amount.
- Beneficial conversion feature (BCF) – Under this model conversion, features are recorded as equity components at intrinsic value and the host contract is recorded at the residual amount.

Remaining models include:

- Embedded derivative – Under this model, conversion features are bifurcated as derivatives from the host contract and measured at fair value. This model is used to account for convertible debt instruments with embedded conversion feature that are not clearly and closely related to the host contract, that meet the definition of a derivative, and that do not meet the criteria for the derivative scope exception.
- Substantial premium – This model is used to account for convertible debt instruments issued at substantial premiums. Under this model, the instrument is bifurcated and the premiums are recorded as paid-in capital.
- Traditional convertible debt – Under this model, there is no separation; the entire instrument is carried at amortized cost as a liability.
- Traditional convertible preferred shares – Under this model, there is no separation; the entire instrument

- is carried at historical cost in equity.
- Mandatorily redeemable convertible preferred shares – No separation; these instruments are accounted for as convertible debt with a cash conversion feature.

Another benefit of a reduction in bifurcation is that the interest rate of more convertible debt instruments would be closer to the coupon interest rate rather than the imputed interest rate that must be calculated based on the separation of the conversion feature.

Derivatives Scope Exception

An entity has to determine whether a contract qualifies for a scope exception from derivative accounting using the two criteria below. This guidance is applied to freestanding financial instruments and embedded features that have all the characteristics of a derivative instrument, as well as freestanding financial instruments that potentially are settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative instrument.

- The contract is indexed to an entity's own stock – indexation guidance
- The contract is equity classified – settlement guidance. A contract that will settle in an entity's own equity shares will meet this criterion while a contract that may or will require cash settlement does not

If both of those criteria are not met, the contract must be recognized as an asset or liability. FASB notes the strict application of the derivatives scope exception guidance results in accounting for some contracts as derivatives while economically similar contracts are accounted for as equity.

If the instrument qualifies for the updated derivatives scope exception criteria, the accounting is as follows:

- Freestanding instrument – An entity should record the instrument in equity
- Embedded feature – An entity should no longer bifurcate the feature and account for it separately

The ASU clarifies that the scope of the disclosure requirements in Accounting Standards Codification (ASC) 815-40-50 applies only to freestanding instruments; those disclosures are not required for embedded features. The amendments also clarify that the scope of the reassessment guidance in ASC 815-40-35 on subsequent measurement applies to both freestanding instruments and embedded features.

Settlement

Previous settlement guidance included seven criteria to be met for a contract to be classified as equity. ASU 2020-06 eliminates three of those criteria because they are unrelated to whether a contract will be cash settled or share settled:

- The contract permits the entity to settlement in unregistered shares
- No collateral required
- No counterparty rights rank higher than shareholder rights

The ASU updates the criteria that no cash payment is required if an entity fails to file on a timely basis with the SEC. The amendments clarify that penalty payments do not preclude equity classification (because they do not result in contract settlement). The ASU's basis for conclusion notes other cash payments such as cash-settled top-off, make-whole provisions, and compensation for the difference between registered and unregistered shares are clearly related to settlement and are not the same as penalty payments.

Indexation

ASU 2020-06 requires instruments that must be classified as an asset or liability under the indexation guidance to be measured subsequently at fair value, with changes reported in earnings and disclosed in the financial statements. This aligns the treatment for instruments that are required to be classified as an asset or a liability under ASC 815-40-25 on recognition.

EPS

There are two methods of calculating diluted EPS—the if-converted method and the treasury stock method. The if-converted method assumes conversion of convertible securities at the beginning of the reporting period (or at issuance, if later). The denominator is adjusted to reflect the potential shares, and the numerator is adjusted to add back any interest and preferred dividends that were included in the income statement during the period. The treasury stock method considers the use of proceeds that could be obtained on option or warrant exercise in computing diluted EPS and assumes that the proceeds would be used to purchase common stock at the average market price during the period. Currently, diluted EPS for many convertible instruments is calculated using the if-converted method. The treasury stock method is for used convertible securities that permit or require the cash payment to the security holder at conversion. ASU 2020-06 improves the consistency of EPS calculations by amending the guidance as follows:

- Align the diluted EPS calculation for convertible instruments by requiring that an entity use the if-converted method. The treasury stock method should no longer be used to calculate diluted EPS for convertible instruments.
- Require that the effect of potential share settlement be included in the diluted EPS calculation when an instrument may be settled in cash or shares. The ASU removes current guidance that allows an entity to rebut this presumption if it has a history or policy of cash settlement.
- Equity-classified convertible preferred stock that includes a down round feature would be included in the scope of the recognition and measurement guidance for financial instruments that include down round features in Topic 260, *Earnings Per Share*, because the BCF model is eliminated.
- Clarify that an average market price should be used to calculate the diluted EPS denominator when exercise prices may change based on an entity's share price or changes in the entity's share price may affect the number of shares that may be used to settle a financial instrument.
- Entities should use the weighted-average share count from each quarter when calculating the year-to-date weighted-average share count. Current guidance requires an entity to calculate an average using the year-to-date period, rather than averaging the quarters.

A. Convertible Disclosures

ASU 2020-06 establishes a disclosure objective to help ensure consistent information to financial statement users, including:

- Information about the terms and features of convertible debt instruments

- An understanding of how those instruments have been reported in an entity's statement of financial position and statement of financial performance
- Information about events, conditions, and circumstances that can affect the assessment about the amount or timing of an entity's future cash flows related to those instruments

Rights & Features

The pertinent rights and privileges of each convertible debt instrument outstanding should be disclosed, including—but not limited to—the following information:

- Principal amount
- Coupon rate
- Conversion or exercise prices or rates and number of shares into which the instrument is potentially convertible
- Pertinent dates, such as conversion date and maturity date
- Parties that control the conversion rights
- Manner of settlement upon conversion and any alternative settlement methods, such as cash, shares, or a combination
- Terms that may change conversion or exercise prices, number of shares to be issued, or other conversion rights and the timing of those rights (excluding standard antidilution provisions)
- Liquidation preference and unusual voting rights, if applicable
- Other material terms and features of the instrument that are not listed above

Contingently Convertible Instruments

An entity shall provide the following incremental information for contingently convertible instruments, a contingently adjustable conversion ratio, or is contingent only on events outside the issuer's control:

- Events or changes in circumstances that would adjust or change the contingency or would cause the contingency to be met
- Information on whether the shares that would be issued if the contingently convertible securities were converted are included in the diluted EPS calculation and the reasons why or why not
- Other information that is helpful in understanding both the nature of the contingencies and the potential conversion impact

Instrument Details

The following information is required for each convertible debt instrument, as of each date for which a statement of financial position is presented:

- The unamortized premium, discount, or issuance costs and, if applicable, the premium amount recorded as paid in capital
- The net carrying amount
- For public business entities, the fair value of the entire instrument and the level of the fair value hierarchy

This information can be presented in a tabular or narrative format.

Conversion Conditions

An entity shall disclose the following information as of the date of the latest statement of financial position presented:

- Changes to conversion or exercise prices that occur during the reporting period, excluding changes due to standard antidilution provisions
- Events or changes in circumstances that occur during the reporting period that significantly affect the conversion conditions
- Number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period

Long-Term Obligation Disclosure

An entity must disclose the maturities and sinking fund requirements for convertible debt instruments for each of the five years following the date of most recent statement of financial position presented.

Interest Expense

An entity shall disclose for each period for which a statement of financial performance is presented, the effective interest rate for the period and the amount of interest recognized for the period disaggregated by both the contractual interest expense and the amortization of the premium, discount, or issuance costs. This can be presented in a narrative or tabular format.

Other Disclosures

If the conversion option of a convertible debt instrument is accounted for as a derivative under ASC 815-15, an entity also should include disclosures in accordance with ASC 815 for the conversion option in addition to the above disclosures. If the fair value option (FVO) is elected for a convertible debt, required disclosure under ASC 820-10 and 825-10 should be included in addition to the above disclosures.

Derivatives Issued With Convertibles

In addition to ASC 815's required derivative disclosures, the following information continues to be required for derivative transactions connected to convertible debt issuance regardless of whether the transactions are accounted for as assets, liabilities, or equity instruments:

- Derivative transactions terms, including the settlement terms
- How those derivative transactions relate to the convertible instruments
- The number of shares underlying the derivative transactions
- The reasons for entering into those derivative transactions

B. Convertible Preferred Stock Disclosures

Objective

The disclosure objective for convertible preferred stock is to provide users of financial statements with:

- Information about the terms and features of convertible preferred stock
- An understanding of how those instruments have been reported in an entity's statement of financial position and statement of financial performance
- Information about events, conditions, and circumstances that can affect the assessment about the amount or timing of an entity's future cash flows related to those instruments

Rights & Privileges

An entity shall explain the pertinent rights and privileges of each outstanding instrument, including—but not limited to—the following information:

- Number of shares issued and par value
- Dividends
- Conversion or exercise prices or rates and number of shares into which the instrument is potentially convertible
- Pertinent dates, such as conversion date
- Parties that control the conversion rights
- Manner of settlement upon conversion and any alternative settlement methods, such as cash, shares, or a combination
- Terms that may change conversion or exercise prices, number of shares to be issued, or other conversion rights and the timing of those rights (excluding standard antidilution provisions)
- Liquidation preference and unusual voting rights
- Other material terms and features of the instrument that are not listed above

Contingently Convertible Instruments

The following incremental information must be disclosed for contingently convertible instruments:

- Events or changes in circumstances that would adjust or change the contingency or would cause the contingency to be met
- Information on whether the shares that would be issued if the contingently convertible securities were converted are included in the diluted EPS calculation and the reasons why or why not
- Other information that is helpful in understanding both the nature of the contingencies and the potential impact of conversion

Dividends

An entity shall disclose the amount of dividends declared for each period for which a statement of financial performance is presented.

Conversion

An entity shall disclose the following as of the date of the latest statement of financial position presented:

- Changes to conversion or exercise prices that occur during the reporting period (excluding changes due to standard antidilution provisions)
- Events or changes in circumstances that occur during the reporting period that significantly affect the conversion conditions
- The number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period.

If a conversion option is accounted for as a derivative under ASC 815-15, an entity shall provide required disclosures in accordance with ASC 815 for the conversion option in addition to the above disclosures.

Other Disclosures

The following information must be disclosed about derivative transactions entered into in connection with the issuance of convertible preferred stock regardless of whether such derivative transactions are accounted for as assets, liabilities, or equity instruments:

- The terms of those derivative transactions (including the terms of settlement)
- How those derivative transactions relate to the instruments within the scope of this Subtopic
- The number of shares underlying the derivative transactions
- The reasons for entering into those derivative transactions

Effective Date & Transition

ASU 2020-06 is already effective for public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2023, including interim periods. Limited early adoption is permitted—no earlier than fiscal years beginning after December 15, 2020. An entity should adopt the guidance as of the beginning of its annual fiscal year.

Entities can irrevocably elect the FVO under ASC 825-10, *Financial Instruments—Overall*, for any financial instrument that is a convertible security upon adoption of ASU 2020-06.

An entity must adopt this guidance as of the beginning of its annual fiscal year. Entitles can use a modified retrospective method or a full retrospective method of transition.

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