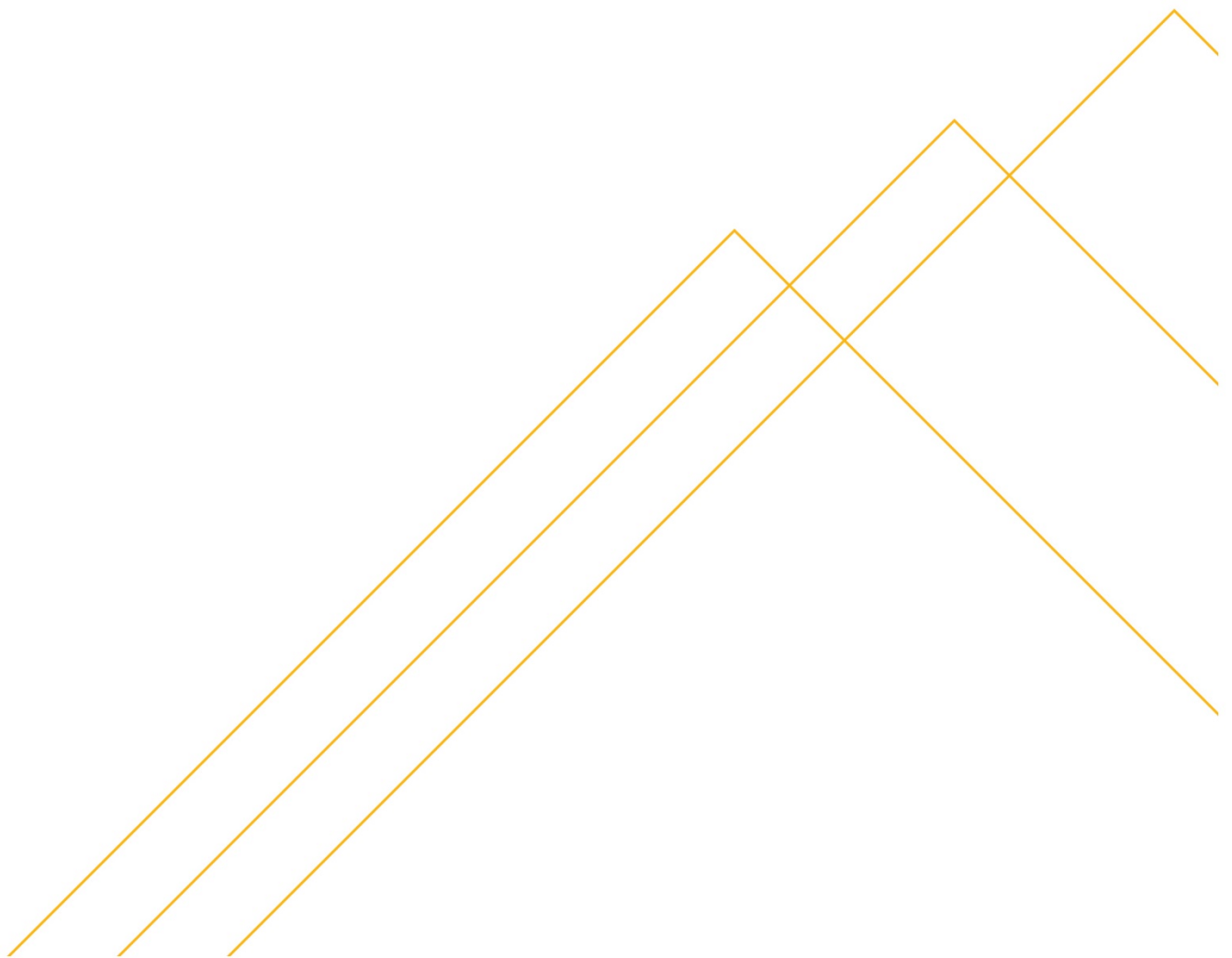


ASU 2020-06: A solution for certain convertible instrument complexities

Matthew A. Geerdes, CPA, and
Christopher L. Moore, CPA



ASU in a minute

- The Financial Accounting Standards Board (FASB) has issued a new Accounting Standards Update (ASU) that significantly changes how convertible instruments (such as convertible debt and convertible preferred stock) will be accounted for under U.S. GAAP.
- Unless an embedded conversion feature satisfies the bifurcation criteria in Topic 815, “Derivatives and Hedging,” reporting entities typically will account for convertible instruments under a simpler approach, with fewer features requiring separate accounting (that is, bifurcation). For example, the beneficial conversion feature (BCF) and cash conversion feature models have been removed from U.S. GAAP.
- Contracts in an entity’s own equity such as embedded conversion features and warrants now have fewer attributes for determining equity classification, as the FASB amended the derivatives scope exception.
- Earnings per share (EPS) calculations have been simplified for certain instruments.
- The ASU takes effect for fiscal years on or after Dec. 15, 2021, for public business entities and on or after Dec. 31, 2023, for all other entities. Early adoption is permitted, but no earlier than fiscal years beginning after Dec. 15, 2020, including interim periods within those fiscal years.
- Companies need to be thinking about the instruments being affected by these changes. This will involve assessing the population of instruments, evaluating previous accounting assessments, reassessing the instruments under the simplified model, recording a possible transition adjustment, and finally reporting on the financial statements using either the modified retrospective or full retrospective approach.

On Aug. 5, 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 \(Subtopic 815-40\)](#).” This addresses concerns from preparers and practitioners regarding the complexity of accounting rules for certain financial instruments and their respective features – namely, convertible debt, convertible preferred stock, and other forms of equity contracts, such as warrants and forward contracts, that reflect both debtlike and equitylike characteristics.

Why the ASU?

The ASU eliminates several legacy accounting models to simplify the accounting for convertible instruments. In addition, the ASU modifies the derivative scope exception guidance to remove certain criteria and clarify others, which likely will result in more instruments being equity classified or having more embedded features remain embedded. The ASU also improves the related financial statement disclosures and EPS guidance.

What instruments are affected, and what changed?

This is a summary of the impact of the ASU:

Examples of instruments potentially affected

- Convertible debt
- Convertible preferred stock
- Warrants
- Forward contracts

Basic impacts

Convertible instruments issued with:

- BCFs
- Cash conversion features

These accounting models have been removed from U.S. GAAP.

What changed in the equity classification considerations for warrants, equity conversion features, and forward contracts?

- A simplified settlement assessment model now removes:
 - Whether the contract would be settled in registered shares
 - Whether collateral is required to be posted
 - Required assessment of shareholder rights
- Instruments having previously failed any of these three criteria may now qualify for the derivatives scope exception for equity classification.
 - ASC 815-40-35-4 as modified now includes instruments that are assets or liabilities due to the requirements of ASC 815-40-15-8A and requires those instruments to be remeasured at fair value subsequently for each reporting period, regardless of whether the instruments meet the definition of a derivative.

What changed for EPS?

This ASU affects diluted EPS calculations, including:

- Use of the if-converted model is required for convertible instruments.
- Share settlement is presumed when an instrument is settled in cash or shares.
- Equity-classified convertible preferred stock with a down round feature is now included within Topic 260.
- Narrower issues related to the use of an average market price for calculation of dilutive EPS are clarified.

What are the effects on convertible instruments?

Under the new ASU, convertible instruments will now more frequently be accounted for as a single unit of account. That is, a conversion feature and the host instrument in which it is embedded now generally will be treated as a single unit of account unless the conversion feature requires bifurcation under Topic 815. The result is that fewer conversion features will be separated from their host contract than under legacy GAAP. The substantial premium model has not been affected by these changes.

The common result is that for convertible debt instruments, a single liability would be measured at its amortized cost, and convertible preferred stock would be accounted for as a single equity instrument measured at its historical cost as long as no other features require bifurcation. A significant consideration is that by reducing the number of accounting models, the interest rate of convertible debt instruments typically would be closer to the coupon interest rate when applying the guidance in Topic 835, "Interest."

The disclosure requirements for convertible instruments also have been expanded – namely, the ASU added a disclosure objective, a requirement to explain the pertinent rights and privileges, alignments between contingently convertible instruments and other convertible instruments, and other information as of the date of the financial statement period being presented. In addition, for public business entities only, entities that do not account for a conversion feature separately from the debt host will be required to disclose the fair value of the convertible debt instrument at the individual instrument level.

What is changing with the derivatives scope exception for ASC 815-40?

For instruments that fall under the scope of ASC 815-40 (warrants, forward contracts, equity conversion features, etc.), the settlement guidance was modified with the expectation that more instruments would be classified as equity, thus simplifying the accounting upon inception and in subsequent reporting periods.

When considering the settlement guidance for instruments within the scope of ASC 815-40, the ASU makes modifications to the equity classification considerations, specifically the following conditions found in the current guidance:

- Settlement in unregistered shares is removed. An additional modification of the guidance is specific to ASC 815-40-25-22, which discusses how a warrant doesn't necessarily imply an entity's inability to deliver shares and thus preclude equity classification.
- Collateral considerations are removed.
- Shareholder right considerations are removed.
- The condition about failure to timely file is modified so that penalty payments do not preclude equity classification.

As a result of these modifications, for a free-standing instrument, if the instrument qualifies for the derivatives scope exception with the modifications under the ASU, an entity would record the instrument in equity. For an embedded feature, if the feature qualifies for the derivatives scope exception under the amendments, an entity no longer would bifurcate and account for the feature separately.

What is changing with EPS?

With the changes in convertible instruments and Topic 815-40 instruments, the related disclosures of EPS that are affected by these instruments also were updated. The ASU modifies Topic 260, "Earnings Per Share," in four areas:

1. The if-converted method now is required to be used for convertible instruments. The treasury stock method will no longer be used to calculate diluted EPS for convertible instruments.
2. Share settlement must be presumed for purposes of calculating diluted EPS when an instrument may be settled in cash or shares, but this applies only if the effect is considered dilutive. Previously, the guidance allowed an entity to rebut this presumption if it had a history or policy of cash settlement. This affects the calculation of both convertible instruments and contracts in an entity's own equity; however, certain liability-classified share-based payments are not affected by the ASU.
3. Equity-classified convertible preferred stock that includes a down round feature will be included in the scope of the recognition and measurement guidance for financial instruments that include down round features in Topic 260, because the beneficial conversion model has been eliminated.
4. Narrower issues related to the use of an average market price for calculation of dilutive EPS are clarified, and entities should use weighted-average share counts from each quarter when calculating the year-to-date weighted-average share count.

When does this all take effect?

The amendments in this ASU are effective as follows:

Public business entities that meet the definition of a Securities and Exchange Commission (SEC) filer, excluding entities eligible to be smaller reporting companies as defined by the SEC

- Fiscal years beginning after Dec. 15, 2021, including interim periods within those fiscal years

All other entities

- Fiscal years beginning after Dec. 15, 2023, including interim periods within those fiscal years

An entity should adopt the guidance as of the beginning of its annual fiscal year using either a modified retrospective or fully retrospective method of transition with the cumulative effect of the change recognized as an adjustment to opening retained earnings in the period of adoption or earliest comparative period presented, respectively. Transactions that were settled (or expired) during prior reporting periods would not be affected. The cumulative effect of the change would be recognized as an adjustment to the opening balance of retained earnings at the date of adoption.

Early adoption of the amendments in this ASU is permitted, but no earlier than fiscal years beginning after Dec. 15, 2020, including interim periods within those fiscal years (that is, an entity must adopt as of the beginning of the year and not in a subsequent interim period).

Specific to convertible instruments with down round features, entities that have not yet adopted ASU 2017-11 may early adopt the amendments in ASU 2020-06 in annual or interim financial statements for fiscal years beginning after Dec. 31, 2019, that have not yet been issued or made available for issuance. The FASB provided this accommodation specifically for convertible instruments that include down round features in order to avoid requiring those entities to apply multiple costly transitions for the same instrument with no benefit to financial statement users. Other instruments affected by the amendments in this ASU should follow the overall effective date guidance previously described.

The ASU also allows for entities to irrevocably elect the fair value option in accordance with Topic 825-10, "Financial Instruments – Overall," for any instrument that has a conversion feature upon adoption.

What do you need to think about?

While the simplified model for convertible instruments and warrants does provide relief to preparers and practitioners, several key considerations for implementation exist:

Identify outstanding instruments that could be affected.

A complete population of the affected instruments and the current measurement of any conversion features in the financial statements is required in order to understand the totality of implementation.

Document the accounting entries for the affected instruments.

Once all the applicable instruments have been identified, transition entries might need to be prepared that might have an impact on opening retained earnings due to the change in accounting principles. For example:

- If a convertible instrument had a BCF previously reported, with implementation of the new guidance, this is no longer required to be accounted for. An entry would be needed to remove the BCF from the balance sheet.
- If cash conversion guidance previously had been applied to a convertible instrument, the separately accounted cash conversion feature in equity would be removed from the balance sheet through an adjusting entry, and the value of the liability component of the instrument also would be adjusted to account for the instrument as a single item of account.
- If a warrant previously had been classified as a liability due to the considerations of registered shares, that warrant could be reassessed and might be reported as an equity instrument. An entry would be required to reclassify the instrument on the balance sheet.

Consider the impacts on the financial statements, including the presentation of single-year financial statements versus comparative financial statements.

This includes:

- All applicable reporting documents, such as management's discussion and analysis and potentially other information, should be reported to the users of the financial statements.
- The presentation of EPS and the impact on shareholders should also be reported, with appropriate explanations regarding the change in accounting principle.

Contact us

Matt Geerdes
+1 630 706 2061
matt.geerdes@crowe.com

Chris Moore
Partner
+1 502 420 4429
chris.moore@crowe.com

“Crowe” is the brand name under which the member firms of Crowe Global operate and provide professional services, and those firms together form the Crowe Global network of independent audit, tax, and consulting firms. “Crowe” may be used to refer to individual firms, to several such firms, or to all firms within the Crowe Global network. The Crowe Horwath Global Risk Consulting entities, Crowe Healthcare Risk Consulting LLC, and our affiliate in Grand Cayman are subsidiaries of Crowe LLP. Crowe LLP is an Indiana limited liability partnership and the U.S. member firm of Crowe Global. Services to clients are provided by the individual member firms of Crowe Global, but Crowe Global itself is a Swiss entity that does not provide services to clients. Each member firm is a separate legal entity responsible only for its own acts and omissions and not those of any other Crowe Global network firm or other party. Visit www.crowe.com/disclosure for more information about Crowe LLP, its subsidiaries, and Crowe Global.

The information in this document is not – and is not intended to be – audit, tax, accounting, advisory, risk, performance, consulting, business, financial, investment, legal, or other professional advice. Some firm services may not be available to attest clients. The information is general in nature, based on existing authorities, and is subject to change. The information is not a substitute for professional advice or services, and you should consult a qualified professional adviser before taking any action based on the information. Crowe is not responsible for any loss incurred by any person who relies on the information discussed in this document. © 2020 Crowe LLP.