The amendments would simplify an issuer’s accounting for convertible instruments and contracts in its own equity.

What you need to know

- The FASB proposed simplifying an issuer’s accounting for convertible instruments by eliminating the requirements in ASC 470-20 to separately account for embedded conversion features. Only embedded conversion features requiring bifurcation in accordance with ASC 815-15 would be accounted for separately.

- The proposal also would simplify an issuer’s accounting for contracts in its own equity (e.g., warrants) by requiring the issuer to disregard remote events in certain circumstances and removing some of the conditions for equity classification in ASC 815-40.

- The proposal would require entities to use the if-converted method for all convertible instruments in the diluted EPS calculation and presume share settlement for instruments that may be settled in cash or shares, except for liability-classified share-based payment awards.

- The proposal would require enhanced disclosures of the terms and conversion conditions of convertible instruments. PBEs would have to disclose the fair value of convertible debt at the instrument level.

- Comments are due by 14 October 2019.

Overview

The Financial Accounting Standards Board (FASB or Board) proposed simplifying an issuer’s accounting for financial instruments with characteristics of liabilities and equity. The proposal would make targeted improvements to the current guidance on convertible instruments and
the derivatives scope exception for contracts in an entity's own equity. The Board's objective is to address feedback from preparers, auditors and users that the current guidance is unnecessarily complex and often results in conclusions based on form rather than substance.

The proposal would eliminate the models for separating embedded conversion features from convertible instruments in Accounting Standards Codification (ASC) 470-20. As a result, only embedded conversion features that are required to be bifurcated in accordance with ASC 815-15 would be accounted for separately. For contracts in an entity's own equity, the proposal would require entities to disregard certain events that would trigger an adjustment to the contract's settlement amount and any events that would trigger net cash settlement, if the likelihood of the event occurring is remote. It also would eliminate some of the requirements in ASC 815-40 for equity classification.

The proposal also would require entities to use the if-converted method for all convertible instruments in the diluted earnings per share (EPS) calculation. In addition, entities would presume share settlement for instruments that may be settled in cash or shares, except for liability-classified share-based payment awards.

The proposal also would require more disclosures about the terms of convertible instruments and contracts in an entity's own equity.

Key considerations

Convertible instruments

The current guidance for convertible instruments provides for the use of various accounting models depending on the terms of the instruments. In some cases, a convertible instrument is accounted for as one unit of account. In other cases, the embedded conversion option is separated from the host contract and accounted for in equity or as a derivative asset or liability. In addition, various measurement models may apply, depending on the terms of the instrument.

Due to this complexity, preparers and auditors often find it difficult to understand and apply the guidance. Based on the Board's outreach, users of financial statements do not find the separation models useful and relevant because they generally analyze convertible instruments on a whole-instrument basis.

The proposal would eliminate the three models in ASC 470-20 that require an issuer of convertible debt and certain preferred stock to separately account for embedded conversion features as a component of equity (i.e., the cash conversion model, beneficial conversion feature model and significant premium model).

Instead, an issuer would account for these securities as a single unit of account, unless the conversion feature meets the criteria in ASC 815-15 to be considered a derivative that must be bifurcated from the host contract.

The proposal also would require issuers of convertible instruments to disclose all pertinent terms and features of those instruments, as well as information about events, conditions and circumstances that can affect the assessment of the amount or timing of an entity's future cash flows related to those instruments. In addition, public business entities (PBEs) would have to disclose the fair value and level of the fair value hierarchy for each convertible debt instrument issued. Currently, PBEs have to disclose the fair value in the aggregate.

Contracts in an entity's own equity

Under current guidance, an entity is required to consider all settlement possibilities in determining whether a contract in its own equity qualifies for equity classification. This often results in contracts being classified as an asset or liability because of remote settlement scenarios.
When evaluating whether an instrument’s settlement provisions are indexed to the issuer’s own equity, an entity would no longer be required under the proposal to consider an event that would trigger an adjustment to a contract’s settlement amount if the likelihood of the event occurring is remote. Likewise, when evaluating an equity contract under the share-settlement requirements in ASC 815-40-25, entities would ignore events that may require net cash settlement by the issuer if the likelihood of the events occurring is remote.

The evaluation of whether the likelihood of events occurring is remote would be performed at inception of the contract, and a reassessment would only be required when either (1) an adjustment to the instrument’s strike price or the number of shares used to calculate the settlement amount occurs, (2) a settlement feature expires or (3) an entity no longer has sufficient authorized and unissued shares to settle the contract. This would be a change from the current guidance, which requires an entity to reassess equity contracts at every reporting date. Accordingly, a reassessment of an equity-classified contract under ASC 815-40 would not be triggered solely by a change in the likelihood of an event occurring that was determined to be “remote” at issuance.

The proposal also would remove certain other conditions that are currently required under ASC 815-40-25 for an equity contract to qualify for equity classification. Entities would no longer have to assess whether an equity contract (1) permits settlement in unregistered shares, (2) requires any collateral or (3) provides the holder with rights that rank higher than shareholder rights upon bankruptcy. In addition, entities would exclude penalty payments from the equity classification assessment under ASC 815-40-25 because they do not settle an equity contract.

**How we see it**

In some cases, determining whether the likelihood of an event occurring is “remote” may be straightforward. In other cases, this determination may require considerable judgment. Issuers would need to consider, among other things, their current circumstances, whether similar events have occurred in the past, the length of the contract and the industry in which the issuer operates.

We believe that eliminating the requirement that a contract permit settlement in unregistered shares would significantly reduce complexity in practice when evaluating these contracts.

The proposal also would require freestanding equity contracts that do not meet the definition of a derivative (e.g., physically settled warrants issued by private companies) to be subsequently measured at fair value through earnings if they are not indexed to an entity’s own equity under ASC 815-40-15. US GAAP does not currently provide measurement guidance for these instruments.

Similar to the proposed requirement for convertible instruments, the proposal would require entities to disclose information about the terms and features of contracts in an entity’s own equity, as well as information about events, conditions and circumstances that affect the assessment of the amount and timing of settlement. These disclosure requirements would be applicable to freestanding instruments that are potentially indexed to, and potentially settled in, an entity’s own equity, regardless of classification.

**EPS calculation**

The proposal would amend the treasury stock method and the if-converted method by clarifying that an average market price should be used when calculating the denominator for instruments for which (1) the exercise price may change based on an entity’s share price or (2) changes in the entity’s share price may affect the number of shares that may be used to settle a financial instrument. The Board believes that the use of the average share price is consistent with the existing requirements of the treasury stock method and provides the most consistent calculations for the if-converted method because an average price would be less volatile than a price determined at a point in time. In addition, the Board believes the proposal would eliminate diversity in practice.
Entities would have to use the if-converted method to calculate diluted EPS for all convertible instruments. Currently, the dilutive effect on EPS is calculated for certain convertible instruments (e.g., convertible debt where, upon conversion, the issuer must pay the principal of the debt in cash but may settle the conversion premium in cash or shares) using the treasury stock method. The proposal would modify the if-converted method so that interest charges on convertible debt for which the principal is required to be paid in cash would not be added back to the numerator when applying the if-converted method. Consistent with the if-converted method, the share price at the beginning of the period would be used in the calculation, unless the number of additional shares is variable. In these cases, entities would use the average share price to calculate the number of shares included in the denominator.

For instruments that may be settled in cash or shares, the proposal would require entities to presume that the instrument will be settled in shares, with an exception for liability-classified share-based payment awards. Entities would no longer be able to overcome the presumption of share settlement, and, as a result, the maximum potential dilution would be reflected in diluted EPS. The current guidance in ASC 260,\(^4\) which would continue to be applied to liability-classified share-based payment awards, requires an entity to presume share settlement but allows it to overcome this presumption if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.

**Effective date and transition**

The FASB proposed a modified retrospective transition approach for most of the proposed amendments. Under this approach, the proposed guidance on convertible instruments and contracts in an entity's own equity would require a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption.

The proposed amendments to the EPS guidance for instruments that may be settled in cash or shares would require a full retrospective approach. The proposal would allow all amendments to be applied retrospectively. Also, the proposal would provide a transition expedient that would allow entities to assess whether the likelihood of features in equity contracts being triggered is remote at the date of adoption, rather than at contract inception.

Early adoption would not be permitted, except for convertible instruments with down-round features issued by entities that have not yet adopted Accounting Standards Update (ASU) 2017-11.\(^5\) The FASB will determine an effective date after considering feedback.

**Endnotes:**

1. ASC 470-20, Debt — Debt with Conversion and Other Options.
2. ASC 815-15, Derivatives and Hedging — Embedded Derivatives.
3. ASC 815-40, Derivatives and Hedging — Contracts in Entity's Own Equity.
4. ASC 260, Earnings Per Share