

Accounting & Auditing Update

FASB: Updates to Simplify Accounting for Convertible Debt, Contracts in an Entity's Own Equity, and EPS

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The Financial Accounting Standards Board (FASB) recently issued Accounting Standards Update (ASU) 2020-06 *Debt – Debt with Conversion and Other Options and Derivatives and Hedging – Contracts in Entity's Own Equity*. This ASU is intended to simplify the following current standards:

- Accounting for convertible instruments
- Contracts in an entity's own equity
- Earnings per share

Convertible Instruments

The new guidance reduces the number of accounting models for convertible debt instruments and convertible preferred stock. This will result in fewer embedded conversion features being separately recognized from the host contract and, accordingly, more convertible debt instruments will be accounted for as a single liability measured at its amortized cost. More convertible preferred stock will be accounted for as a single equity instrument measured at its historical cost.

The following are convertible instruments that continue to be subject to separation models:

- those with embedded conversion features that are not clearly and closely related to the host contract, that meet the definition of a derivative, and that do not qualify for a scope exception from derivative accounting; and
- convertible debt instruments issued with substantial premiums for which the premiums are recorded as paid-in capital.

In addition, the following disclosure amendments were added for convertible instruments:

- Information on the terms and features of the convertible debt instrument, an understanding of how those instruments have been reported in an entity's financial statements, and information about events, conditions, and circumstances that can affect how to assess the amount or timing of an entity's future cash flows related to those instruments.
- The pertinent rights and privileges of each convertible debt instrument outstanding, including: (1) the principal amount, (2) the coupon rate, (3) conversion or exercise prices or rates and number of shares into which the instrument is potentially convertible, (4) parties that control the conversion rights, (5) conversion and maturity dates, (6) the manner of settlement upon conversion and any alternative settlement methods (e.g., cash, shares, or a combination thereof), (7) terms that may change conversion or exercise prices, the number of shares to be issued, or other conversion rights and the timing of those rights (excluding standard antidilution provisions), (8) liquidation preferences and unusual voting rights, applicable, and (9) any other material terms or features.
- For contingently convertible instruments: (1) events or changes in circumstances that would adjust or change the contingency or would cause the contingency to be met, (2) information on whether the shares that would be issued if the contingently convertible securities were converted

are included in the calculation of diluted EPS and the reasons for including or excluding them, and (3) other information deemed helpful in understanding the nature of the contingency and the potential impact of conversion.

- For convertible debt instruments: (1) the unamortized premium, discount, or issuance costs, and, if applicable, the premium amount recorded as paid-in capital, (2) the net carrying amount, and (3) fair value information and the level in the fair value hierarchy (public business entities only).
- Events or changes during the reporting period that significantly affect the conversion conditions, other than changes due to standard antidilution provisions.
- The number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period.
- Maturities and sinking fund requirements for each of the five years following the date of the most recent balance sheet.
- Information about interest, recognized for each period for which an income statement is presented: (1) the effective interest rate, and (2) the amount of interest recognized, separately for contractual interest expense and the amount of amortization of premium, discount, or issue costs.

Contracts in an Entity's Own Equity

The new guidance simplifies the settlement assessment by removing the requirements: (1) to consider whether the contract would be settled in unregistered shares, (2) to consider whether collateral is required to be posted, and (3) the condition that the contract does not contain provisions indicating that the counterparty has rights ranking higher than those of a holder of the stock underlying the contract.

In addition, ASU 2020-06 adds guidance:

- To exclude penalties on the settlement condition for equity classification that failure to file timely with the Securities and Exchange Commission does not require a cash payment.
- That requires instruments classified as an asset or a liability to be subsequently measured at fair value, with changes reported in earnings and disclosed in the financial statements.
- To clarify the scope of the reassessment of a contract's classification on subsequent measurement applies to both freestanding instruments and embedded features.
- To clarify that the scope of the disclosure requirements applies only to freestanding instruments.

Earnings per Share

Under the new guidance, the treasury stock method for calculating diluted earnings per share for convertible instruments will no longer be available. Entities will be required to apply the if-converted method to all convertible instruments. The if-converted method assumes that the conversion of convertible securities occurs at the beginning of the reporting period. Interest expense and dividends recognized during the period are added back to the numerator and the denominator includes the common shares issuable upon conversion of convertible securities. Under the current guidance, the treasury stock method applies to certain convertible securities that require or permit the issuer to settle some or all of the conversion value in cash upon conversion and assumes that the cash proceeds that would be received upon exercise are then used to purchase common shares at the average market price during the period.

In addition, ASU 2020-06 provides the following amendments:

- **Share settlement presumption in calculation of diluted earnings per share** – under current guidance, share settlement is presumed for contracts that may be settled in cash or stock at the election of the counterparty, and that presumption may not be rebutted if the effect is more dilutive than the cash settlement. Share settlement is also presumed for contracts that may be settled in cash or stock at the election of the issuer, but an entity may be able to rebut that

presumption depending on its facts and circumstances. Under the new guidance, an entity may not rebut the presumption of share settlement.

- **Equity classified preferred stock with down-round features** – for financial instruments that include down-round features, if the down-round feature is triggered, its effect is treated as a dividend and as a reduction of income available to common shareholders in basic earnings per share. However, the scope of the new guidance does not include convertible debt with down-round features.
- **Average market price** – the new guidance clarifies that the average market price should be used to calculate the diluted earnings per share denominator when the exercise price or the number of shares that may be issued is variable, except for certain contingently issuable shares.

Effective Date

The guidance in ASU 2020-06 may be adopted either through the full retrospective or modified retrospective transition method.

The standard is effective for public entities (excluding smaller reporting companies) for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years.

For all other entities (including smaller reporting companies) the standard is effective for fiscal years beginning after December 15, 2023, including all interim periods within those fiscal years.

Contact Us

If you have any questions about these FASB updates – or any other accounting and auditing matters – please contact the partner in charge of your account or:

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