FASB Simplifies Accounting for Complex Financial Instruments

Summary: The FASB issued ASU 2020-061 ("Update") to simplify the accounting for convertible instruments by eliminating large sections of the existing guidance in this area. It also eliminates several triggers for derivative accounting, including a requirement to settle certain contracts by delivering registered shares. These changes are intended to make GAAP easier to apply, and therefore, reduce the frequency of errors in this part of the literature. The new ASU is available [here](#), and early adoption is permitted for fiscal years beginning after December 15, 2020.

BACKGROUND

The current accounting guidance for convertible instruments is complex and difficult to navigate, which has contributed to a large number of restatements in the past. Additionally, the current guidance for the exception to derivative accounting can result in form-over-substance-based accounting conclusions. The FASB issued this Update to simplify the current guidance for convertible instruments and the derivatives scope exception for contracts in an entity’s own equity. Additionally, the amendments affect the diluted EPS calculation for instruments that may be settled in cash or shares and for convertible instruments. The Update also provides for expanded disclosure requirements to increase transparency.

1 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

2 See "2019 Financial Restatements – A Nineteen Year Comparison" by Audit Analytics, page 23 (July 2020). From 2001 – 2019, errors in accounting for financial instruments with characteristics of both debt and equity have represented from 15% to 27% of total restatements each year based on public disclosures in Item 4.02 of Item 8-K for SEC filers.
MAIN PROVISIONS

The Update amends the following issues:

► **Issue 1:** Reduce the number of accounting models for convertible instruments

Existing guidance for convertible instruments contains five methods for determining the accounting for convertible debt. Except for the traditional convertible debt model that recognizes a convertible debt instrument as a single debt instrument, the other four models, with their different measurement guidance, 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 is evaluated similarly. This Update simplifies the accounting for convertible instruments by eliminating the models that require separation of a cash conversion or beneficial conversion feature from the host contract. Therefore, a convertible debt instrument is treated as one liability accounted for at its amortized cost and convertible preferred stock is considered one equity instrument accounted for at its historical cost, unless (a) there are other features that require bifurcation as a derivative, or (b) convertible debt was issued at a substantial premium. Consequently, interest rates for these convertible debt instruments will now be more reflective of the stated coupon rate.

The Update adds a disclosure objective and provides for enhanced disclosures, including aligning disclosure requirements for contingently convertible instruments with those for other convertible instruments. The expanded disclosures require (i) information on circumstances that cause conversion contingencies to be met or terms to be significantly changed and which party controls the conversion rights, (ii) certain information for convertible debt instruments issued at a substantial premium, including the premium amount recorded as paid-in capital, and (iii) existing fair value disclosures in ASC 825-3 be provided at the individual convertible instrument level rather than in the aggregate.

► **Issue 2:** Revise the derivatives scope exception

Existing guidance requires a freestanding contract on an entity’s own equity, or an embedded derivative (e.g., a conversion option in convertible debt), to meet certain requirements to be eligible for the derivatives scope exception and be classified as equity. This involves evaluating the contract’s settlement optionality and the conditions necessary for share settlement. Generally, a contract that will settle in an entity’s own equity shares meets the settlement test, whereas a contract that may (or will) require settlement in cash does not. Existing guidance includes seven other conditions that may require net cash settlement, which leads to derivative accounting (adjusting the instrument to fair value every period through earnings).

In this context, the Update simplifies the derivatives scope exception by:

- Removing three of the conditions required to avoid derivative accounting: the ability to deliver registered shares upon settlement, a collateral requirement, and certain counterparty rights;
- Clarifying the condition about failure to timely file such that penalty payments in an instrument do not preclude equity classification;
- Confirming instruments that are not indexed to the issuer’s stock under 815-40-15-8A must be remeasured at fair value through earnings each reporting period;
- Clarifying that the scope of the disclosure requirements in ASC 815-40-50 applies only to freestanding instruments, and not to embedded derivatives; and
- Clarifying that the scope of the reassessment guidance in ASC 815-40-35 on subsequent measurement is applicable for both freestanding instruments and embedded features.

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3 Financial Instruments
4 ASC 815-40, Derivatives and Hedging—Contracts in Entity’s Own Equity
**BDO Observation:** The FASB originally proposed amendments that would have added a remote threshold to allow an entity to disregard certain contingent events when applying the derivatives scope exception and changed the reassessment frequency. However, because of mixed feedback, the Board was unable to determine whether those proposed amendments would be operable and/or auditable and decided to exclude them from the final Update. Instead, the Board added a separate project to its technical agenda, Distinguishing Liabilities from Equity Phase 2, to consider additional improvements to the guidance and reduce inconsistencies across GAAP.

**Issue 3:** Provide targeted improvements for EPS

The Update also provides the following clarifications to improve the consistency of earnings per share (EPS) calculations:

- Diluted EPS is required to be calculated using the if-converted method for convertible instruments. The treasury stock method is no longer allowed for such instruments.

- If the financial instrument can be settled in shares or cash, an entity must assume that the instrument will be settled in shares when calculating diluted EPS. An entity is no longer allowed to rebut this presumption if it has a history of or policy of settling the instrument in cash. This affects any instrument that may be settled in cash or shares (other than certain liability-classified share-based payment arrangements) and, therefore, affects the diluted EPS calculation for both convertible instruments and contracts in an entity's own equity.

- Because the beneficial conversion feature model is eliminated, the scope of the earnings per share guidance in ASC 260 for financial instruments with down round features is expanded to include equity-classified convertible preferred stock with such features (if the conversion feature has not been bifurcated under other guidance).

- In calculating diluted EPS, the calculation of the denominator should utilize the average market price in situations where exercise prices may vary on the basis of an entity's share price or changes in the share price may affect the number of shares used to settle a financial instrument.

- The weighted average count from each quarter should be used when calculating the year-to-date weighted-average share count.

**EFFECTIVE DATES AND TRANSITION**

For SEC filers, excluding smaller reporting companies, this Update is effective for fiscal years beginning after December 15, 2021 including interim periods within those fiscal years. For all other entities, this Update is effective for fiscal years beginning after December 15, 2023, including interim periods therein. Upon adoption, companies have the option to apply a modified or full retrospective transition approach. In applying the modified retrospective method, a company should apply the guidance to transactions outstanding as of the beginning of the fiscal year of adoption and recognize the cumulative effect of the change as an adjustment to opening retained earnings. If a company adopts by applying the full retrospective method, the cumulative effect of the Update should be recognized in the opening balance of retained earnings for the first comparative period presented.

Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods therein. The Update specifies that the guidance should be adopted as of the beginning of the annual fiscal year.

**BDO Observation:** SEC filers considering early adoption should be mindful of this limitation. For example, a calendar year-end entity with liability-classified warrants that will be reclassified to equity upon adoption will only be permitted to early adopt in the first quarter ended March 31, 2021. Early adoption in the second, third or fourth quarter of 2021 is not permitted.

An entity that has not yet adopted ASU 2017-11
\[5\]\ may early adopt the amendments that apply to down-round features in convertible instruments for fiscal years beginning after December 15, 2019. This may result in such an entity adopting the ASU at different dates for different instruments.

Entities are permitted to irrevocably elect the fair value option in accordance with ASC 825-10\[5\]\ for any liability-classified financial instrument that is a convertible security upon adoption of the amendments in this Update.

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5 Accounting Standards Update No. 2017-11, Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480), Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception

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