Josef Rashty, CPA, Ph.D. (Candidate) received his M.S. in accounting from Oklahoma State University and provides consulting services in Silicon Valley, Calif. He can be reached at jrashty@josefrashty.com.

The new guidance for convertible debt instruments

By Josef Rashty, CPA, Ph.D.

Self-Study CPE Details

Interest Area: Corporate Finance

Designed for: CPAs in public practice and industry

Objective: Understand new guidance for convertible debt instruments.

Level: Basic
Prerequisite: None

MUST BE COMPLETED AND SUBMITTED BY FEB. 28, 2021 TO QUALIFY.

In August 2020, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2020-06, "Debt—Debt 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," which simplifies accounting for certain financial instruments with characteristics of liabilities and equities. This ASU is part of the FASB's simplification initiative to reduce unnecessary complexities of U.S. Generally accepted accounting principles (GAAP). This guidance removes the separation models that exist under the current guidance for convertible debt with a cash conversion feature (CCF) and convertible instrument with a beneficial conversion feature (BCF).

ASU 2020-06 (the new guidance) addresses concerns related to the complexity of GAAP for certain financial instruments with characteristics of liabilities and equity. In this guidance, FASB reduced the number of accounting models for convertible debt instruments and convertible preferred stock and limited the accounting models such that the new guidance results in fewer embedded conversion features being separately recognized from the host contract as compared with current GAAP. Finally, this ASU amended diluted earnings per share (EPS) for convertible debts that may result in a lower EPS in certain circumstances.

This article explicates the provisions of ASU 2020-06. The author believes that this guidance simplifies the GAAP reporting requirements for convertible debts significantly and brings the utmost accounting clarity to these types of transactions.

Effective Dates

This guidance is effective for public business entities (PBEs) that are not small reporting entities for fiscal years beginning after Dec. 15, 2021, and interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after Dec. 15, 2023, and interim periods within those fiscal years. FASB allows early adoption for fiscal years beginning after Dec. 15, 2020, and interim periods within those fiscal years. Entities should adopt the guidance at the beginning of their annual fiscal years. Entities may follow one of the following transition methods:

- Modified retrospective method, where entities apply the guidance to all financial instruments that are outstanding as of the beginning of the year of adoption and reflect the cumulative-effect adjustments as an adjustment to the opening balance of retained earnings at the year of adoption. (EPS presentations for prior periods are not restated.)

- Full retrospective method, where cumulative-effect adjustments are reflected to the opening balance of retained earnings in the first comparative period presented for all financial instruments outstanding for each reporting period. Therefore, EPS presentations for prior periods are also restated.

Companies may also irrevocably elect the fair value option for any liability-classified convertible financial instrument that is eligible under Subtopic 825-10.

Current U.S. GAAP

PBEs that issue a convertible debt, which can be settled in cash or shares at the issuer's option, are required to separate the instrument into two different components (with limited exceptions): liability and equity units of account. The new guidance eliminates some of the separation models that exists in the current guidance.

Furthermore, although the new guidance

maintains the conversion option that meets the definition of a derivative, it limits certain criteria and makes it easier for equity-linked features to qualify for scope exception from derivative accounting. This may reduce earnings volatility due to the mark to market requirement of derivative accounting.

The New Guidance

CCF Instruments: Companies may issue certain convertible debt instruments that can be settled in cash (or other assets) upon conversion. ASU 2020-06 removes the separation model of CCF that separates the debt from the equity component in convertible debt securities. The legacy GAAP requires companies to use with-and-without method, where they measure the nonconvertible debt component at fair value and allocate the residual amount to equity. The new guidance no longer retains this method for convertible debt instruments with CCF and requires that entities reflect the whole fair value of the instrument as liabilities.

The existing guidance recognizes four types of structured convertible debt (ASC 470-20):

1. Instrument A, where the issuer satisfies the entire obligation in cash;
2. Instrument B, where the issuer can satisfy the entire obligation in either stock or cash;
3. Instrument C, where the issuer satisfies the accreted value of the obligation in cash and satisfies the conversion spread (the excess conversion value over the accreted value) in either cash or stock; and
4. Instrument X, where the issuer can satisfy the conversion value of the debt in shares or cash or any combination of the two.

The new guidance eliminates the requirement that companies allocate the fair value of the instrument to liability and equity for instruments B, C and X, thereby creating a discount on the debt, which is then amortized through interest expense over the expected life of the instrument. Therefore, companies reflect the whole amount of the instrument as liabilities. Both the existing guidance and the new guidance classify instrument A (the traditional convertible debt) as liability.

BCF Instruments: The BCF model applies to convertible debt and convertible preferred stock with non-detachable conversion features that are "in the money" at the commitment date (which is usually the issuance date) and are not subject to derivative guidance in ASC 815. Under the existing guidance, accounting for BCF instruments is similar to accounting for CCF instruments, where companies use the with-and-without method to measure the equity based on its intrinsic value and allocate the residual amount to the host contract. However, the new guidance eliminates the requirement that companies allocate the fair value of the instrument to liability and equity; therefore, they reflect the whole amount of the instrument as liabilities.

Instruments at a Substantial Premium: ASU 2020-06 did not make any changes to accounting for such instruments and records the substantial premium that it has received in equity. Companies use the with-and-without method to measure the debt first at its principal amount (par value) and allocate the residual amount (any excess proceeds above the par) to equity (additional paid-in capital).

Instruments with Embedded Derivatives: ASC 815 requires companies to record derivatives at fair value and reflect any changes in their fair values (unless they qualify for hedge accounting) in earnings. The current guidance requires that if a contract has a settlement criterion that requires cash settlement outside the control of the issuer, it is not an equity instrument and therefore should be classified as assets and liabilities. The current guidance has a list of conditions that ASU 2020-06 eliminates:

- Under the current guidance, the issuer must substantiate that the contract permits settlement in unregistered shares. ASU 2020-06 removes this condition and eliminates the need to obtain a legal assessment when companies issue instruments in a registered or unregistered offering.
- Under the current guidance, if the provisions in the contract indicate the instrument holders have rights that rank higher than those of shareholders, the instrument fails the settlement criterion. ASU 2020-06 explicitly removes this condition.
- Under the current guidance, an instrument fails the settlement criterion if there is a requirement in the contract to post collateral (except the company's share underlying the contract) for any reason. ASU 2020-06 removes this condition and argues that collateral may be returned, thus it is not a cash consideration.
- Additionally, ASU 2020-06 clarifies that if a company fails to make timely filings with the SEC, the penalty payment, if any, would preclude meeting the settlement criterion.

Contingent BCF: ASC 470-20-05-08 states that certain convertible debts may have a contingency adjustable conversion ratio, which makes the conversion price dependent on a future event (e.g., an IPO or a liquidation). Under the current guidance, if a contingent BCF has been triggered (ASC 470-20-25-6), the issuer recognizes a contingent BCF when the contingency is resolved (e.g., an IPO).

When FASB issued ASU 2020-06, the amendments in the proposed ASU included a remote likelihood threshold that would have allowed an entity to disregard certain contingent events when applying the derivatives scope exception. However, because of the mixed views that it received during its outreach, FASB was unable to determine the operability and auditability of the those proposed amendments. To avoid delaying the ASU, FASB removed the amendments related to the remote likelihood threshold from that project's scope and decided to further explore improvements at a later date. FASB is currently discussing this project and may issue an amendment to ASU 2020-06 in the near future.

Diluted Earnings per Share Calculation: EPS is the most common and complex performance measurement that a PBE presents in its quarterly and annual reports. ASC 260 defines EPS as the amount of income attributable to each share of common stock. Companies calculate their basic EPS by dividing their net income to the weighted average number of the common stock shares outstanding during the period, whereas diluted EPS includes all dilutive potential common shares that are outstanding during the period as its denominator. There are two different methods for calculation of diluted EPS: treasury stock method (TSM) and if-converted method:

- **TSM:** Companies use TSM to calculate their diluted EPS. TSM basically assumes that a company uses the proceeds from the hypothetical exercise of the awards to repurchase common stock at the average market price during the period. Therefore, a higher amount of assumed proceeds (the numerator) and a lower average market price during the reporting period (the denominator) will increase the number of shares that a company can repurchase. An increase in the number of shares that a company can hypothetically repurchase lowers the denominator and increases the diluted EPS. TSM calculation is no longer available under ASU 2020-06 for convertible debt instruments.

- **If-Converted Method:** Under the existing guidance, companies may also use if-converted method to calculate their diluted EPS. If-converted method assumes that conversion of convertible securities occurs at the beginning of the reporting period for the calculation of denominator (the denominator includes the common shares issuable upon conversion of convertible debt securities as if the conversion has occurred), and it adds back the interest expense and dividends recognized during the period to numerator.

ASU 2020-06 requires use of if-converted method and modifies this method so interest expense is no longer added back to the numerator when the principal is required to be settled in cash, and the denominator only includes the net number of incremental shares that companies may hypothetically issue upon conversion. Furthermore, under the current guidance, if the issuer has the option to settle the instrument in cash or shares, it can rebut the share settlement presumption based on its past experience or a stated policy. However, ASU 2020-06 requires companies to include the presuming share settlement, that may be settled in cash or shares, if the effect is more dilutive. Companies no longer have the option to rebut this presumption. The only exception is for liability-classified share-based awards, for which the share settlement presumption may be rebutted based on past experience or stated policy.

Convertible debts are a hybrid between a bond and a stock, and, like bonds, they have a coupon that pays a set interest rate and provides a steady return. However, unlike a bond, if the companies' stock prices rise above a certain threshold, the holder can convert the bond to stock for a tidy profit. Many industries that were hit hard due to Covid-19 have found convertible debts an inexpensive way to stay afloat through the pandemic and have flooded the market with convertible bond offerings not seen since 2007.

This ASU and several other recently issued guidance offer the public an effective solace that U.S. GAAP is moving more toward a principled-base framework. FASB has perforce to simplify U.S. GAAP to avoid any further entanglement of business concepts with accounting guidance. Furthermore, in addition to simplification, this guidance will most likely propel the use of convertible debt as an important source of corporate financing subsequent to its adoption.

CPE Self-Study Section: Earn CPE credit for reading the article on pages 12-14.
Earn one hour of CPE credit by reading the preceding CPE article and completing the provided self-study exam. Mail in the completed exam by Feb. 28, 2021, to the OSCPA Education Department for grading. If you receive a score of 70% or higher, you will be issued a certificate for one hour of CPE credit, dated as of when the test arrives in the OSCPA office. If you score below a 70%, you will be notified of your score and may be allowed to retake the exam. The answers for this exam will be printed in the next issue of the CPA*FOCUS*.

CPE EXAM: The new guidance for convertible debt instruments *(Please mark your answers.)*

1. Entities may follow one of the following transition methods for adoption of ASU 2020-06:

___ a. Prospective or modified prospective
___ b. Modified retrospective or full retrospective
___ c. Modified prospective or modified retrospective
___ d. Prospective or full retrospective

2. Under the existing guidance (prior to ASU 2020-06) for convertible debts, accounting for BCF instruments is _______________ to accounting for CCF instruments:

___ a. Substantially different
___ b. Different
___ c. Similar
___ d. Irrelevant

3. ASC 815 requires that companies record derivatives at fair value and reflect any changes in their fair values (unless they qualify for hedge accounting) in ________________.

___ a. Other comprehensive income
___ b. Asset section of balance sheet
___ c. Equity section of balance sheet
___ d. Earnings

4. Treasury stock method calculation is ___________ under ASU 2020-06 for convertible debt instruments:

___ a. No longer available
___ b. Available
___ c. Available on a limited basis
___ d. Available conditionally

5. The article claims that many industries that were hit hard due to COVID-19 have found convertible debts _____________way to stay afloat through the pandemic.

___ a. An expensive
___ b. A problematic
___ c. An inexpensive
___ d. A secure

Answers for November-December 2020 CPE Self-Study article: 1) A, 2) B, 3) D, 4) C, 5) C

Participant Evaluation

Please use the following scale to complete the below evaluation: 1=strongly disagree; 2=disagree; 3=neutral; 4=agree; 5=strongly agree

1) The stated learning objectives were adequately met.	❍ 1	❍ 2	❍ 3	❍ 4	❍ 5
2) The author conveyed a strong knowledge of the subject matter.	❍ 1	❍ 2	❍ 3	❍ 4	❍ 5
3) The article was timely and relevant.	❍ 1	❍ 2	❍ 3	❍ 4	❍ 5
4) The article and exam were well-suited to my background, education and experience.	❍ 1	❍ 2	❍ 3	❍ 4	❍ 5

My overall rating for the self-study program is: ❍ Poor ❍ Fair ❍ Average ❍ Very Good ❍ Excellent
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