Publications in Deloitte’s Roadmap Series

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Business Combinations — SEC Reporting Considerations
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Acknowledgments

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Preface

April 2020

To our clients, colleagues, and other friends:

We are pleased to present the 2020 edition of *A Roadmap to the Issuer’s Accounting for Convertible Debt*. This Roadmap provides an overview of the requirements in ASC 470-20 related to convertible debt and our insights into and interpretations of how to apply them in practice. For ease of reference, we have accompanied our discussion with the related authoritative text and other relevant literature.

Determining the appropriate accounting for convertible debt instruments can often be time-consuming and complex and frequently requires the involvement of technical accounting specialists. To properly apply the numerous rules and exceptions in U.S. GAAP, an issuer may need to closely analyze an instrument’s terms and conditions and the related facts and circumstances. The outcome of this analysis can significantly affect the classification, measurement, and earnings impact of the convertible instrument and the associated financial statement ratios.

This Roadmap is intended to help an issuer navigate the guidance, organize its analysis, and arrive at appropriate accounting conclusions. Note that as of the 2020 Roadmap’s publication date, the FASB is deliberating amendments to ASC 470-20 that would significantly affect the issuer’s accounting for convertible debt instruments. The Board plans to finalize the amendments and issue an ASU later this year (see Chapter 1).

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the Roadmap from the Roadmap Series page on DART. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

We hope you find this Roadmap to be a useful resource, and we welcome your suggestions for future improvements. If you need assistance with applying the guidance or have other questions about this topic, we encourage you to consult our technical specialists and other professional advisers.

Sincerely,

Deloitte & Touche LLP

1 For a list of the titles of standards and other literature referred to in this publication, see Appendix E. For a list of abbreviations used in this publication, see Appendix F.
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Chapter 1 — Overview

ASC 470-20 provides guidance on an issuer's accounting for instruments with embedded equity conversion features as well as certain transactions related to such instruments. Examples of contracts and transactions that may require evaluation under ASC 470-20 (see Chapter 2) include:

- Debt that is convertible into the issuer's equity shares (i.e., convertible debt).
- Shares that are convertible into a different class of the issuer's shares (i.e., convertible stock).
- Instruments that are convertible into the issuer's equity shares (including induced conversions and conversions upon the issuer's exercise of a call option).
- Debt issued with detachable warrants.
- Own-share lending arrangements issued in contemplation of a convertible debt issuance.

Navigating the guidance in U.S. GAAP on convertible debt instruments can be challenging since there are multiple disparate sets of classification, measurement, and derecognition requirements whose interactions are complex. Seemingly unimportant differences in the terms of otherwise identical convertible debt instruments can result in significantly different accounting. Consequently, accounting restatements are not uncommon. At the 2005 AICPA Conference on Current SEC and PCAOB Developments, then Acting Chief Accountant Scott Taub commented on the complexity of financial reporting related to these instruments:

An example: try walking through all of the literature that applies (or might apply) to the issuance of convertible debt. Amongst the pieces of accounting literature that might apply are [ASC 470-20-25-12, ASC 815-40-25, the beneficial conversion option requirements in ASC 470-20, ASC 815, ASC 480, ASC 825-20, and ASC 480-10-S99-3A]. And it isn't exactly obvious how these pieces of literature interact with one another in all circumstances.

To save time, an issuer may seek to organize its accounting analysis in a manner broadly consistent with the order of precedence among the various classification, measurement, and separation requirements that might apply to a transaction involving convertible instruments (see Section 3.2). Before applying a specific accounting approach, the issuer should (1) carefully evaluate the contractual terms (see Section 3.3), (2) determine whether the transaction involves multiple freestanding financial instruments or should be combined with other items (see Section 3.4), and (3) if necessary, allocate the initial transaction amount among multiple freestanding financial instruments (see Section 3.5).
The following table indicates whether ASC 470-20 addresses classification and measurement requirements that might apply to different types of convertible debt instruments and where those requirements are discussed in detail in this Roadmap:

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
<th>Addressed in ASC 470-20</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional convertible debt</td>
<td>Convertible debt to which no special accounting approach applies</td>
<td>Yes</td>
<td>Chapter 4</td>
</tr>
<tr>
<td>Convertible debt issued at a substantial premium to par</td>
<td>Convertible debt that was issued at a substantial premium to par and to which no other special accounting approach applies</td>
<td>Yes</td>
<td>Chapter 5</td>
</tr>
<tr>
<td>Cash conversion feature (CCF)</td>
<td>Debt (or liability-classified stock) that may be settled in whole or in part in cash upon conversion unless the conversion feature is required to be separated as an embedded derivative</td>
<td>Yes</td>
<td>Chapter 6</td>
</tr>
<tr>
<td>Beneficial conversion feature (BCF)</td>
<td>Debt that contains a conversion feature that is beneficial to the holder unless that feature is required to be separated as an embedded derivative or as an equity component under the CCF requirements</td>
<td>Yes</td>
<td>Chapter 7</td>
</tr>
<tr>
<td>Embedded derivative</td>
<td>Debt that contains an embedded feature (e.g., a conversion option, a put or call option, or a contingent interest provision) that is required to be separated from its host contract and accounted for as a derivative instrument under ASC 815</td>
<td>No</td>
<td>Sections 2.3 and 2.4 and Appendixes A and B</td>
</tr>
<tr>
<td>Interest method</td>
<td>Debt (or a debt host that remains after separation of an embedded derivative, or a liability component that remains after separation of an equity component)</td>
<td>Some aspects</td>
<td>Sections 4.4, 5.4, 6.4, and 7.4</td>
</tr>
<tr>
<td>Fair value option</td>
<td>Debt that does not contain a separated equity component (elective)</td>
<td>No</td>
<td>Section 2.5</td>
</tr>
<tr>
<td>Temporary equity</td>
<td>Convertible debt instruments that contain a separately recognized equity component that must be classified outside of permanent equity because the instruments are redeemable for cash (1) at a fixed or determinable date or (2) upon the occurrence of an event that is outside the issuer's control</td>
<td>No</td>
<td>Section 2.6</td>
</tr>
</tbody>
</table>

Further, if a convertible instrument is issued in the form of a share, the issuer should determine whether the instrument is required to be classified as a liability under ASC 480-10 before evaluating the potential applicability of other approaches for convertible instruments. If such classification is required and the instrument contains a CCF, it may be subject to the CCF guidance in ASC 470-20 (see Section 6.2.2). Note that this Roadmap only addresses convertible instruments issued in the form of a share that require classification as a liability. For further discussion of the requirements in ASC 470-20 that apply to equity-classified convertible preferred stock, see Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share.*
Under U.S. GAAP, there are multiple approaches to the derecognition of convertible debt:

<table>
<thead>
<tr>
<th>Approach</th>
<th>Addressed in ASC 470-20</th>
<th>Traditional Convertible Debt</th>
<th>CCFs</th>
<th>BCFs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conversion in accordance with the original terms</td>
<td>Yes</td>
<td>Section 4.5.2</td>
<td>Section 6.5.1</td>
<td>Section 7.6.1</td>
</tr>
<tr>
<td>Conversion upon the issuer’s exercise of a call option</td>
<td>Yes</td>
<td>Section 4.5.3</td>
<td>Section 6.5.1</td>
<td>Section 7.6.1</td>
</tr>
<tr>
<td>Induced conversion</td>
<td>Yes</td>
<td>Section 4.5.4</td>
<td>Section 6.5.2</td>
<td>Section 7.6.1</td>
</tr>
<tr>
<td>Debt extinguishment</td>
<td>Some aspects</td>
<td>Section 4.5.5</td>
<td>Section 6.5.1</td>
<td>Section 7.6.2</td>
</tr>
<tr>
<td>Debt modification or exchange</td>
<td>Some aspects</td>
<td>Section 4.5.6</td>
<td>Section 6.5.3</td>
<td>Section 7.6.3</td>
</tr>
<tr>
<td>Troubled debt restructuring (TDR)</td>
<td>No</td>
<td>Section 4.5.7</td>
<td>Section 4.5.7</td>
<td>Section 4.5.7</td>
</tr>
<tr>
<td>Related-party transaction</td>
<td>No</td>
<td>Section 4.5.5.3</td>
<td>Section 4.5.5.3</td>
<td>Section 4.5.5.3</td>
</tr>
</tbody>
</table>

ASC 470-20 also includes guidance on accounting for equity-classified own-share lending arrangements that are issued in contemplation of a convertible debt issuance or other financing (see Chapter 8).

Entities that apply both U.S. GAAP and the equivalent guidance in IFRS® Standards should note that there are significant differences between the two sets of guidance. See Chapter 9 for a discussion of those differences.

Appendix D of this Roadmap contains the definitions of selected terms from ASC 470-20 and the ASC master glossary.

Practitioners still sometimes refer to the original accounting pronouncements that were in effect before the FASB’s codification of U.S. GAAP in 2009 (e.g., APB Opinion 14, FSP APB 14-1, FASB Statement 84, and EITF Issues No. 98-5 and 00-27). The FASB’s August 4, 2016, Invitation to Comment, Agenda Consultation, notes that “practice continues to use the legacy literature rather than the Accounting Standards Codification to address issues about the classification of specific instruments as either liabilities or equity,” in part because “[c]omplexity and difficulties with interpretation and application were not addressed when the FASB developed the Accounting Standards Codification.” However, the texts of those original pronouncements are no longer recognized as sources of authoritative GAAP.

This Roadmap includes excerpts from some of the tentative guidance and bases for conclusions that were referred to or included in those original pronouncements. While nonauthoritative, these texts can help practitioners interpret and apply GAAP requirements in a manner consistent with their purpose. Appendix C of this Roadmap contains a list of pronouncements that were codified in ASC 470-20.

Connecting the Dots

For further discussion of some of the requirements that are not in ASC 470-20 but may nevertheless affect the accounting for convertible debt instruments, see Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity (which addresses ASC 815-40) and A Roadmap to Distinguishing Liabilities From Equity (which addresses ASC 480-10).
The following ASUs have amended the guidance in ASC 470-20:

- **ASU 2009-15** (issued in October 2009) incorporated the EITF’s consensus on accounting for own-share lending arrangements in contemplation of a convertible debt issuance or other financing (see Chapter 8).
- **ASU 2012-04** (issued in October 2012) made certain technical corrections related to BCFs (see Chapter 7) to conform the Codification to the pre-Codification guidance in EITF Issue 00-27.
- **ASU 2015-01** (issued in January 2015) removed the concept of extraordinary items.
- **ASU 2016-19** (issued in December 2016) removed the previous definition of the term debt (see Section 2.2).
- **ASU 2018-07** (issued in June 2018) revised certain requirements related to convertible instruments issued to nonemployees for goods or services (see Section 2.8).
- **ASU 2019-08** (issued in November 2019) amended ASC 470-20 to clarify the measurement of convertible instruments that are issued as consideration payable to a customer (see Section 2.8).

With the exception of ASU 2019-08, which is discussed in Section 2.8, it is assumed in this Roadmap that an entity has adopted the ASUs listed above as well as ASU 2016-02, ASU 2016-04, ASU 2017-11, and ASU 2018-09.

**Changing Lanes**

In July 2019, the FASB issued a proposed ASU that would simplify the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity’s own equity. The proposed guidance is part of the FASB’s simplification initiative, which aims to reduce unnecessary complexity in U.S. GAAP. Comments on the proposal were due by October 14, 2019.

The proposed ASU would remove the separation models in ASC 470-20 for (1) convertible debt issued at a substantial premium (see Chapter 5), (2) convertible debt with a CCF (see Chapter 6), and (3) convertible instruments with a BCF (see Chapter 7). As a result, an entity would not separately present embedded conversion features in equity under ASC 470-20 when initially recognizing a convertible instrument. Instead, it would account for a convertible debt instrument wholly as debt (i.e., as a single unit of account) unless the instrument contains features that require bifurcation as a derivative under ASC 815 (see Section 2.3 and Appendix A).

The application of the existing separation models in ASC 470-20 involves (1) the recognition of a debt discount, which is amortized to interest expense (for convertible instruments with a BCF or CCF), or (2) the recognition of a debt premium in equity (for convertible instruments issued at a substantial premium). The elimination of these models would reduce reported interest expense and increase reported net income for entities that have issued convertible debt within the scope of those models.

The proposed ASU would also change (1) the analysis of whether an embedded conversion feature meets the derivative scope exception for contracts that are indexed to, and classified in, stockholder’s equity (see Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity) and (2) the computation of earnings per share (EPS) for convertible debt instruments (see Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share). For more information on the proposed ASU, see Deloitte’s August 8, 2019, Heads Up.
On December 11, 2019, the FASB affirmed its decision to require an entity to account for convertible debt instruments as a single unit of account, except in circumstances in which the conversion feature must be bifurcated as a derivative under ASC 815.

At the February 5, 2020, Board meeting, the FASB decided to “[r]equire an entity to apply a modified retrospective method of transition with an option for full retrospective transition” with “specific transition disclosures in [ASC 250] based on the method of transition selected.” It also decided that the final ASU “will be effective for:

1. Public business entities that are not smaller reporting companies (as defined by the SEC), for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years . . .

2. All other entities, for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.”

Further, the Board decided to give entities “an option for early adoption for fiscal periods beginning after December 15, 2020 (including interim periods within the same fiscal year).”

As of the date of this publication, we expect the FASB to issue a final ASU in the third quarter of 2020 that will include the decisions made to date. However, the Board could make changes at subsequent FASB meetings. Companies should work with their auditors and accounting advisers to evaluate the potential impact, monitor developments, and consider the need for disclosure.
Chapter 2 — Scope

2.1 Overview
This chapter provides an overview of the types of contracts and transactions that are within the scope of ASC 470-20 (see Section 2.2 below) and discusses specific scope considerations related to the following:

- Embedded derivatives (see Section 2.3).
- Share-settled redemption or indexation features (see Section 2.4).
- The fair value option (see Section 2.5).
- Temporary equity (see Section 2.6).
- Debt that can be exchanged for another entity's stock (see Section 2.7).
- Convertible instruments issued to nonemployees for goods or services (see Section 2.8).

2.2 General Considerations

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-1</strong> This Subtopic provides accounting and reporting guidance for debt (and certain preferred stock) with specific conversion features and other options as follows:</td>
</tr>
<tr>
<td>a. Debt instruments with detachable warrants</td>
</tr>
<tr>
<td>b. Convertible securities — general</td>
</tr>
<tr>
<td>c. Beneficial conversion features</td>
</tr>
<tr>
<td>d. Interest forfeiture</td>
</tr>
<tr>
<td>e. Induced conversions</td>
</tr>
<tr>
<td>f. Conversion upon issuer's exercise of call option</td>
</tr>
<tr>
<td>g. Convertible instruments issued to nonemployees for goods and services</td>
</tr>
<tr>
<td>h. Own-share lending arrangements issued in contemplation of convertible debt issuance.</td>
</tr>
<tr>
<td><strong>05-1A</strong> This Subtopic presents guidance in the following two Subsections:</td>
</tr>
<tr>
<td>a. General</td>
</tr>
<tr>
<td>b. Cash Conversion</td>
</tr>
<tr>
<td><strong>15-1</strong> The guidance in this Subtopic applies to all entities.</td>
</tr>
<tr>
<td><strong>15-2</strong> The guidance in this Subtopic applies to all debt instruments. The guidance on beneficial conversion features and conversion features that reset applies also to convertible preferred stock. The guidance in the General Subsections does not apply to those instruments within the scope of the Cash Conversion Subsections. The guidance on own-share lending arrangements applies to an equity-classified share-lending arrangement on an entity's own shares when executed in contemplation of a convertible debt offering or other financing.</td>
</tr>
</tbody>
</table>
The guidance in ASC 470-20 applies to both public business entities (including SEC registrants) and private companies that are issuers of instruments within its scope.

ASC 470-20 provides guidance on the issuer's accounting for the following financial instruments:

- Convertible debt (i.e., debt instruments that contain a feature that requires or permits conversion into the issuer's equity shares), including:
  - Traditional convertible debt (see Chapter 4).
  - Convertible debt issued at a substantial premium to par (see Chapter 5).
  - Convertible debt with a CCF (see Chapter 6).
  - Convertible debt with a BCF (see Chapter 7).
- Convertible shares (i.e., shares that require or permit conversion into a different class of the issuer's equity shares):
  - Liability-classified shares with a CCF (see Section 6.2.2).
  - Equity-classified shares with a BCF.\(^1\)
- Own-share lending arrangements executed in contemplation of a convertible debt issuance (see Chapter 8).
- Debt issued with detachable warrants (or options) on the issuer's equity shares (see Sections 3.4.2.3 and 4.5.2.3).
- Debt exchangeable for third-party stock (see Section 2.7).
- Convertible instruments issued to nonemployees for goods or services (see Section 2.8).

Although ASC 470-20-15-2 specifies that ASC 470-20 applies broadly to debt instruments, most of its guidance only addresses debt instruments that are convertible into the issuer's equity shares. However, ASC 470-20 applies to certain aspects of the accounting for debt issued with detachable warrants (or options) on the issuer's equity shares (see Sections 3.4.2.3 and 4.5.2.3). In determining the appropriate accounting for debt that does not contain a conversion feature, an entity considers other accounting guidance, including ASC 470-10, ASC 470-50, ASC 470-60, ASC 825-10, and ASC 835-30.

The ASC master glossary and ASC 470-20-20 previously included a definition of the term "debt" that specified that it involves "a contractual obligation to pay money on demand or on fixed or determinable dates." However, in ASU 2016-19, the FASB removed the definition because the Board did not consider it "to be robust enough" in contexts other than TDRs (e.g., part of the definition linked the term to restructuring situations).

Although ASC 470-20 is in the liabilities area of the Codification and the titles of ASC 470 and ASC 470-20 suggest that they address debt, some of the guidance in ASC 470-20 also applies to instruments in the form of shares as well as certain equity-classified share-lending arrangements. Thus, ASC 470-20 contains guidance on convertible shares that either (1) contain a CCF and are required to be classified as liabilities under ASC 480-10-15-4 (see Section 6.2.2) or (2) contain a BCF even if they are classified as equity. Further, ASC 470-20 contains accounting guidance that applies to equity-classified share-lending arrangements on the entity's own shares for arrangements that were entered into in contemplation of a convertible debt offering or other financing (see Chapter 8). The issuer applies ASC 480-10 and ASC 815-40 to evaluate whether the arrangement qualifies as equity.

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\(^1\) As discussed below, this Roadmap only addresses accounting considerations for convertible instruments issued in the form of a share that are classified as liabilities.
Connecting the Dots

For a discussion of how an issuer evaluates whether a financial instrument qualifies as equity, see Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*, which addresses ASC 815-40, and *A Roadmap to Distinguishing Liabilities From Equity*, which addresses ASC 480-10.

This Roadmap only addresses accounting considerations for convertible instruments in the form of debt and convertible instruments issued in the form of a share that require classification as a liability (i.e., convertible instruments classified in permanent or temporary equity are not specifically addressed). Therefore, the term “convertible debt instruments” in this publication refers exclusively to those instruments.

### 2.3 Embedded Derivatives

#### 2.3.1 Interaction Between ASC 470-20 and ASC 815-15

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-1</strong> The guidance in this Section shall be considered after consideration of the guidance in . . . Subtopic 815-15 on bifurcation of embedded derivatives . . .</td>
</tr>
</tbody>
</table>

Many of the requirements in ASC 470-20 related to the accounting for convertible debt instruments (e.g., the CCF and BCF guidance) do not apply to a conversion feature that must be bifurcated and accounted for as derivative instrument under ASC 815-15. Therefore, an issuer needs to determine whether ASC 815-15 requires bifurcation of the conversion feature before it assesses whether ASC 470-20 applies. However, if a feature other than the conversion feature (e.g., a call or put option) must be bifurcated from a convertible debt instrument, the conversion feature is not exempt from analysis under ASC 470-20. For example, an entity may be required to separate a convertible debt instrument into liability and equity components under the CCF or BCF guidance in ASC 470-20 even if the instrument contains a bifurcated derivative other than the embedded conversion feature.

Connecting the Dots

For further discussion of the scope of ASC 470-20 and its application to convertible debt instruments that contain an embedded derivative under ASC 815-15, see Sections 2.4, 3.2, 3.5.4, 6.2.4.1, 6.3.2.2, 6.3.6, and 7.2.2.

#### 2.3.2 Bifurcation

##### 2.3.2.1 Overall Framework

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Embedded Derivative</strong></td>
</tr>
<tr>
<td>Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Hybrid Instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>A contract that embodies both an embedded derivative and a host contract.</td>
</tr>
</tbody>
</table>
Chapter 2 — Scope

**ASC 815-15**

<table>
<thead>
<tr>
<th>25-1</th>
<th>An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.</td>
</tr>
<tr>
<td>b.</td>
<td>The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.</td>
</tr>
<tr>
<td>c.</td>
<td>A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of Subtopic 815-10 and this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)</td>
</tr>
</tbody>
</table>

To determine whether any embedded feature in a convertible instrument must be bifurcated and accounted for separately as a derivative instrument, an entity must evaluate the instrument’s terms, which may include, for example, one or more of the following features:

- A right or obligation to convert the instrument into the issuer’s equity instruments (e.g., common or preferred stock), including a right or obligation that is contingent on the occurrence of a specified event (e.g., debt that is mandatorily convertible into the issuer’s equity shares upon an initial public offering (IPO)).
- The holder’s right to require the issuer to accelerate the repayment of the stated amount (i.e., a put or redemption option).
- The issuer’s right to prepay the stated amount (i.e., a call option).
- Terms that accelerate the repayment of principal or interest upon the occurrence or nonoccurrence of an event (e.g., a default or an IPO).
- Term-extension features.
- Indexed principal or interest payments (e.g., to benchmark interest rates, credit spreads, inflation rates, commodity prices, equity prices, revenues, or other underlyings).
- Interest payments that are leveraged or inversely related to market interest rates or subject to a collar, cap, or floor.
- Interest payments that are triggered upon the occurrence or nonoccurrence of an event that is unrelated to an interest rate index or the issuer’s credit risk.
- Foreign currency features.

Under ASC 815-15-25-1, an entity is required to separately account for a feature embedded within another contract (the host contract) if the following three conditions are met:

- The embedded feature and the host contract have economic characteristics and risks that are not clearly and closely related. For example, changes in the fair value of an equity interest — such as an equity conversion feature — are not clearly and closely related to changes in the interest rates on a debt host contract.
- The hybrid instrument (i.e., the combination of the embedded feature and its host contract) is not remeasured at fair value, with changes in fair value recorded immediately through earnings (e.g., under the fair value option election in ASC 815-15-25-4 or ASC 825-10).
• The embedded feature — if issued separately — would be accounted for as a derivative instrument under ASC 815-10. In evaluating whether this condition is met, the entity considers the definition of a derivative in ASC 815-10 and the scope exceptions from derivative accounting in ASC 815-10 and ASC 815-15.

There is no requirement to evaluate the three bifurcation conditions in any particular order. Because all three must be met, the analysis can be simplified if it is readily apparent that any one condition is not satisfied. For example, if the instrument is accounted for at fair value, with changes in fair value recognized in earnings (such as under the fair value option in ASC 825-10), the feature would not be bifurcated irrespective of whether the other two bifurcation conditions are met (see Section 2.5). Therefore, evaluation of the other conditions might not be necessary.

Similarly, the analysis can be simplified if it is readily apparent that the feature is clearly and closely related to the host contract or would not be accounted for as a derivative instrument if it was a freestanding contract.

In determining whether bifurcation is required, the entity should not rely solely on how terms are formally described in the contractual provisions but also should consider the economic payoff profile of the various terms. For example, a term that is described as a conversion option might more appropriately be evaluated as a put option if it represents a right for the investor to receive shares worth a fixed monetary amount upon exercise (see Sections 2.4 and 3.3). We believe that in practice, it may be appropriate to evaluate terms with similar economic payoff profiles on a combined basis. For example, the contractual terms might include multiple conversion features, such as conversion features that are at the option of the issuer or holder or are contingent on different events. If their economic payoff profiles are similar (e.g., they all economically represent a feature that is convertible into the issuer's common stock), it may be appropriate to evaluate them for bifurcation as a single embedded feature.

In its balance sheet, an entity typically presents a bifurcated embedded derivative on a combined basis with the host contract. In the SEC's Current Accounting and Disclosure Issues in the Division of Corporation Finance (as updated November 30, 2006), the SEC staff stated that “although bifurcated for measurement purposes, embedded derivatives should be presented on a combined basis with the host contract, except in circumstances where the embedded derivative is a liability and the host contract is equity.”

### 2.3.2.2 Condition 1 — Not Clearly and Closely Related

The first bifurcation condition in ASC 815-15-25-1 is that the embedded feature and the host contract have economic characteristics and risks that are not clearly and closely related. In evaluating whether this condition is met, the entity must determine the nature of the host contract and identify the economic characteristics and risks of the embedded feature. A convertible instrument issued in the form of debt is considered to contain a debt host contract. A convertible instrument issued in the form of a share must be evaluated to determine whether it contains a debt or an equity host contract (see Section A.2).

The table below provides examples of embedded features that may or may not be considered clearly and closely related to a debt host contract. The embedded features are defined on the basis of the economic profile of the payment rather than the form used for settlement (i.e., cash or shares).

Note, however, that the assessment could differ depending on the facts and circumstances and the application of other specific requirements of ASC 815.

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2 In some cases, an entity will need to determine whether the embedded conversion feature would require bifurcation before the entity can apply the fair value option. This is because ASC 825-10-15-5(f) precludes application of the fair value option to any financial instrument that is, in whole or in part, classified by the issuer as a component of shareholders' equity (including temporary equity) (e.g., a convertible debt instrument within the scope of the Cash Conversion subsections of ASC 470-20 or a convertible debt instrument that contains a noncontingent BCF). See Sections 2.5 and 3.2.
<table>
<thead>
<tr>
<th>Host Contract</th>
<th>Clearly and Closely Related</th>
<th>Not Clearly and Closely Related</th>
</tr>
</thead>
</table>
| Debt          | • Fixed, noncontingent interest and principal payments  
                • Payments indexed to an interest rate or interest rate index unless either the “negative-yield” test or “double-double” test in ASC 815-15-25-26 is met (see Sections A.6 and A.7)  
                • Credit-sensitive interest payments linked to the creditworthiness of the debtor (ASC 815-15-25-46; see Section A.8)  
                • A contingent call or put option that can accelerate the repayment of principal if the debt does not involve a significant premium or discount (ASC 815-15-25-42; see Section A.5)  
                • A noncontingent call option that can accelerate the repayment of principal and does not fail the negative yield test in ASC 815-15-25-26(a) (ASC 815-15-25-29; see Section A.6)  
                • A noncontingent put option that can accelerate the repayment of principal and does not fail the negative yield test in ASC 815-15-25-26(b) (ASC 815-15-25-38; see Sections A.6 and A.7)  
                • Nonleveraged principal or interest payments indexed to the rate of inflation in the economic environment for the currency in which the debt instrument is denominated (ASC 815-15-25-50)  
                • Options to extend the term if, upon exercise, the interest rate is reset to the approximate current market rate and the instrument was not issued at a discount (ASC 815-15-25-44) | • An equity conversion feature (ASC 815-40-25-51)  
                • A put or call option that has a payoff indexed to an underlying other than interest rates or credit risk (step 2 of ASC 815-15-25-42; see Section A.5)  
                • A contingent put or call option if the debt involves a substantial premium or discount (steps 3 and 4 of ASC 815-15-25-42; see Section A.5)  
                • A noncontingent call option that fails the negative yield test in ASC 815-15-25-26(a) (ASC 815-15-25-29; see Section A.6)  
                • A noncontingent put option that fails the double-double test in ASC 815-15-25-26(b) (ASC 815-15-25-38; see Sections A.6 and A.7)  
                • Payments indexed to an interest rate or interest rate index that fail the negative yield test in ASC 815-15-25-26(a) (see Section A.6)  
                • Payments indexed to an interest rate or interest rate index that fail the double-double test in ASC 815-15-25-26(b) (see Sections A.6 and A.7).  
                • Credit-sensitive payments linked to a credit exposure other than the creditworthiness of the debtor (ASC 815-15-25-47; see Section A.8)  
                • Payments of additional interest based on the occurrence or nonoccurrence of specified events unrelated to an interest rate index or the credit risk of the issuer (ASC 815-15-25-46; see Section 3.4.3)  
                • Options to extend the term if the interest rate is not reset to the approximate current market rate (ASC 815-15-25-44)  
                • Commodity-indexed payments (ASC 815-15-25-48)  
                • Equity-indexed payments (ASC 815-40-25-49) |

### 2.3.2.3 Condition 2 — Hybrid-Instrument Accounting

The second bifurcation condition in ASC 815-15-25-1 is that the hybrid instrument is not remeasured at fair value, with changes in fair value recognized in earnings. If an issuer has applied the fair value option in ASC 815-15-25-4 or ASC 825-10 to a convertible debt instrument (see Sections 2.5 and 3.2), an embedded feature would not be bifurcated. Note, however, that ASC 825 prohibits an entity from electing the fair value option for a financial instrument that would be classified, in whole or in part, as equity. Because ASC 470-20 requires the issuer of certain types of convertible debt instruments to separate them into liability and equity components at issuance (e.g., instruments with CCFs or noncontingent BCFs), the issuer cannot elect the fair value option for such instruments. Effectively,
therefore, an issuer needs to consider whether ASC 470-20 requires the convertible debt instrument to
be separated into liability and equity components before it can determine whether the fair value option
is available for that instrument.

When assessing whether an embedded feature must be bifurcated, an entity should not consider a
liability that is measured at settlement value in accordance with ASC 480-10-35-3 (see Sections 4.3.1.2
and 5.3.1.3 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity) to be accounted for at
fair value. Although the settlement value might approximate fair value, the calculation of a liability’s
settlement value does not take into account all of the attributes of an instrument that are included in a
fair value estimate — for example, the time value of an option. Thus, an instrument that is remeasured
at settlement value may contain an embedded feature that must be bifurcated.

2.3.2.4 Condition 3 — Derivative Instrument

The third bifurcation condition in ASC 815-15-25-1 is that the embedded feature would have been
accounted for as a derivative instrument under ASC 815 if it were a separate freestanding instrument.
To determine whether this condition has been satisfied, the entity evaluates whether the feature
(1) would have met the definition of a derivative instrument in ASC 815-10 on a stand-alone basis and
(2) meets any scope exception described in ASC 815-10 and ASC 815-15. An embedded feature would
not be bifurcated if it does not meet the definition of a derivative instrument or it qualifies for a scope
exception.

To determine whether the embedded feature would have met the definition of a derivative instrument
on a freestanding basis, an entity considers whether the instrument possesses the three characteristics
of a derivative instrument listed in ASC 815-10-15-83:

• It has one or more underlyings and one or more notional amounts or payment provisions or both —
The settlement of a derivative depends on the interaction between (1) one or more underlyings
and (2) one or more notional amounts or payment provisions or both, defined as follows:
  ◦ An underlying is a variable whose changes affect the cash flows or fair value of the contract.
Examples of underlyings include security prices, commodity prices, interest rates, exchange
rates, or the occurrences or nonoccurrences of a specified event. For example, one
underlying of an embedded conversion feature is the issuer’s stock price.
  ◦ A notional amount is a quantity specified in the contract. Examples of notional amounts
include monetary amounts (e.g., principal or face amounts) or a number of equity shares.
  ◦ A payment provision is a clause that, as indicated in ASC 815-10-15-93, “specifies a fixed
or determinable settlement [amount] if the underlying behaves in a specified manner.”
Examples include fixed payments that are contingent on the occurrence or nonoccurrence of
an event.

• It requires no initial net investment or one that is smaller than that required under comparable
contracts — Under ASC 815-10-15-83(b), a derivative “requires no initial net investment or an
initial net investment that is smaller than would be required for other types of contracts that
would be expected to have a similar response to changes in market factors.” In accordance with
ASC 815-15-25-1(c), the initial investment in a hybrid instrument is not considered the initial net
investment for an embedded feature in that instrument. Instead, the initial net investment in the
embedded feature is the amount an entity would have been required to invest in a freestanding
contract with terms that are similar to those of the embedded feature. For example, the initial
net investment in a conversion feature embedded in a debt instrument is the fair value of that
feature, rather than the fair value of the convertible debt or the shares that would be delivered
upon exercise of the conversion feature. Thus, the initial net investment characteristic is generally met for an embedded derivative.

- **Net settlement is permitted** — Under ASC 815, a contract or feature is not considered a derivative unless it can be settled net. The net settlement characteristic is met in any of the following circumstances:
  - The contractual terms require or permit net settlement. In a contractual net settlement, neither party is required to deliver an asset that is associated with the underlying and whose principal amount, stated amount, face value, number of shares, or other denomination is equal to the notional amount. One form of contractual net settlement is a one-way transfer of cash or assets, such as a net amount of cash or a net number of shares ("cashless exercise"). If the contractual terms require or permit either party to elect net settlement, the net settlement characteristic is met even if the item delivered upon settlement is not readily convertible to cash (e.g., private-company shares). In accordance with ASC 815-10-15-107, the exercise of an embedded put, call option, or prepayment option in a debt host contract is considered a contractual net settlement “because neither party is required to deliver an asset that is associated with the underlying.”
  - An established market mechanism exists that facilitates net settlement outside of the contract, such as the ability to sell the derivative on an exchange. This condition is typically not met for an embedded feature.
  - The contract is settled in a manner in which the recipient’s position is not substantially different from that in a net settlement. For example, if a contract is settled by a two-way (gross) exchange of items that are readily convertible to cash or are derivatives, the net settlement characteristic is met. According to the ASC master glossary, the term “readily convertible to cash” means that an asset has both “[i]nterchangeable (fungible) units” and “[q]uoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.” For example, an embedded conversion feature that must be settled by the physical delivery of the shares underlying the feature in exchange for the extinguishment of the host debt contract would meet the net settlement characteristic if the shares are readily convertible to cash.

In addition, to determine whether the embedded feature would have been accounted for as a derivative under ASC 815 if it had been a freestanding contract, the entity should consider whether any of the scope exceptions in ASC 815-10-15 and ASC 815-15-15 apply to the feature. Examples of exceptions that may be relevant for embedded features in convertible debt instruments include those related to:

- Contracts that are both indexed to the entity’s own stock and classified in stockholders’ equity (see ASC 815-10-15-74(a) and Section 2.3.3). For example, an entity would evaluate an embedded conversion feature to determine whether it meets this scope exception.

- Certain loan commitments (see ASC 815-10-15-69 through 15-71). For example, an entity may evaluate a term extension option embedded in a debt instrument to determine whether it meets this scope exception.

- Certain contracts traded on an exchange if, as indicated in ASC 815-10-15-59(d), the underlying on which the settlement is based is “[s]pecified volumes of sales or service revenues of one of the parties to the contract.” For example, an entity would evaluate interest payments indexed to sales revenue to determine whether they meet this scope exception.

- Registration payment arrangements (see ASC 815-10-15-82 and Section 3.4.3).
2.3.3 Bifurcation Analysis for Embedded Conversion Features

The application of the bifurcation conditions to an equity conversion feature embedded in a debt instrument is multifaceted and often complex. Although there are additional factors that should be considered (see Appendix A), the analysis of whether an equity conversion feature should be bifurcated from a debt host contract under ASC 815-15 often centers on whether the feature meets (1) the net settlement characteristic in the definition of a derivative and, if so, (2) the scope exception in ASC 815-10-15-74(a) for certain contracts issued by the reporting entity that are both indexed to its own stock and classified in stockholders’ equity in its statement of financial position. If an equity conversion feature is embedded in a contract in the legal form of a share (e.g., convertible preferred stock) but the hybrid financial instrument is classified as a liability for accounting purposes, the host contract is generally a debt host (see Section A.2). Therefore, the analysis is similar to that of an equity conversion feature embedded in a legal-form debt instrument (i.e., the equity conversion feature is not clearly and closely related to the host contract).

For equity conversion features that require physical settlement into a fixed number of shares, whether the conversion option meets the net settlement characteristic in the definition of a derivative often depends on whether the underlying shares are readily convertible to cash. The net settlement criterion would be met if the instruments require or permit explicit net settlement (either in net cash or net shares). In evaluating whether a conversion feature meets the net settlement characteristic, the entity should consider all of the convertible instrument’s terms (e.g., redemption and liquidation features). Sometimes, a conversion feature stipulates that rather than having shares delivered, the issuer or investor may choose to have the instrument settle in a cash amount equal to the value of the shares that would have been received in exchange for the convertible instrument. In this case, the terms of the conversion feature explicitly permit net settlement. Other times, the instrument may be redeemable by the holder and, upon redemption, the holder receives a cash amount equal to the greater of (1) the face value plus accrued interest or (2) the value of the shares that would be received had the holder exercised the conversion option. While the conversion feature, according to its terms, may only be settled physically, the redemption feature effectively permits the conversion feature’s net cash settlement.

The determination of whether an embedded equity conversion feature meets the scope exception for certain contracts on the entity’s own equity includes an evaluation of whether the feature is considered indexed to own equity under ASC 815-40-15 and, if so, whether the feature meets additional equity classification conditions in ASC 815-40-25. Common convertible debt terms that should be considered as part of this analysis include:

- Exercise contingencies (e.g., conversion rights that are contingent on (1) the satisfaction of a share price condition or a convertible debt trading price condition or (2) specified corporate events); see Section 4.2 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity.
- Conversion rate adjustments (e.g., antidilution adjustments, down-round protection, and fundamental change make-whole features); see Section 4.3 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity.
- Settlement provisions (e.g., contingent cash settlement provisions); see Chapter 5 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity.
A convertible debt instrument might qualify as conventional convertible debt under ASC 815-40-25-39 if the holder can realize the value of the conversion option only by exercising it and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash at the issuer's discretion. In that case, some of the equity classification conditions in ASC 815-40-25 would not apply (see Section 5.5 of Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity*).

Note that a conversion feature might begin or cease to meet the bifurcation criteria under ASC 815-15 after the initial recognition of the instrument in which it is embedded. For instance, the assessment of whether a feature meets the equity classification conditions in ASC 815-40-25 may change if the entity authorizes the issuance of additional shares. The accounting analysis might also change if a conversion feature becomes readily convertible to cash because a market develops for the underlying shares. In these circumstances, the applicability of ASC 470-20 to the instrument may be affected. To ensure that the accounting for an instrument remains appropriate, the issuer should monitor such changes (see Section 5.4 of Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity*).

If separation of the conversion feature is required after the initial recognition of the convertible instrument, the feature is bifurcated and recognized at fair value at the time it begins to meet the bifurcation criteria. If no amount was previously allocated to equity, a portion of the current carrying amount of the convertible instrument equal to the current fair value of the feature is allocated to the embedded derivative (in accordance with ASC 815-15-30-2). However, if an amount attributable to the equity feature was previously allocated to equity under the CCF guidance in ASC 470-20, the difference between that amount and the fair value of the conversion option as of the date of reclassification is accounted for under ASC 470-20-35-19 as an adjustment to equity.

If a conversion feature that was bifurcated from its host contract subsequently meets the conditions for equity classification in ASC 815-40, it would no longer meet the bifurcation criteria in ASC 815-15 and therefore should no longer be classified as an asset or a liability. However, any previously recognized gains and losses should not be reversed. Instead, the carrying amount of the embedded derivative (i.e., the feature's fair value as of the date of the reclassification) should be reclassified to shareholders’ equity (see Section 6.4.2 of this Roadmap and Section 6.4 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*). Any remaining debt discount (that arose from the original bifurcation) should continue to be amortized. The entity also should provide the disclosures required by ASC 815-15-50-3, as applicable.

Appendix A of this publication includes additional guidance on key aspects of the embedded derivative analysis that an issuer performs for a convertible debt instrument.

### 2.4 Share-Settled Redemption or Indexation Features

A financial instrument may contain a term that is described as a “conversion” feature but economically represents a share-settled redemption provision. That is, the number of equity shares to be delivered is variable and is calculated to be equal in value to a fixed or specified monetary amount (e.g., the principal amount plus accrued and unpaid interest) or a monetary amount that is indexed to an unrelated underlying (e.g., the price of gold).

Even if the terms of the instrument refer to the share-settled feature as a conversion feature, the issuer should not analyze it as such under ASC 470-20 since a share-settled feature does not have the economic payoff profile of an equity conversion feature. Instead, the issuer should (1) evaluate the feature as a put, call, redemption, or other indexed feature, as applicable, and (2) determine whether the feature must be separated as a derivative instrument under ASC 815-15 (see Section 2.3 and Appendix A). (If the instrument is issued in the form of an equity share such as preferred stock, the issuer should also evaluate whether it must be classified as a liability under ASC 480-10.) This view is consistent
with the guidance in ASC 470-20-25-8 as well as with ASC 470-20-55-19, which exempts “a convertible instrument [that] has a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date” from the application of the accounting guidance on contingent BCFs in ASC 470-20 when those resets subsequently occur (see Section 7.2.3).

Example 2-1

Share-Settled Redemption Feature in Preferred Stock
A liability-classified instrument issued in the form of preferred stock with a liquidation preference amount of $1 million contains a contingent conversion feature that requires the issuer to settle the instrument in a variable number of common shares when a qualified financing occurs. The conversion price is defined as $1.2 million divided by the market price of the common stock on the conversion date. The issuer would not analyze the instrument as a convertible instrument under ASC 470-20. Instead, it should analyze the feature as a contingent redemption provision and evaluate whether the feature must be separated as a derivative instrument under ASC 815-15.

Example 2-2

Share-Settled Indexation Feature in Debt Instrument
A debt instrument with a principal amount of $1 million contains a conversion feature that gives the holder the option to require the issuer to settle the instrument in a variable number of common shares worth $1 million, adjusted for changes in the S&P 500 Index, as of the conversion date. The issuer should not analyze the debt instrument as a convertible debt instrument under ASC 470-20. Instead, it should analyze the feature as indexed to the S&P 500 Index and evaluate whether it must be separated as a derivative instrument under ASC 815-15.

2.5 Fair Value Option

ASC 470-20

25-1 The guidance in this Section shall be considered after consideration of the guidance in the Fair Value Options Subsections of Subtopic 825-10.

ASC 825-10

15-4 All entities may elect the fair value option for any of the following eligible items:
   a. A recognized financial asset and financial liability, except any listed in the following paragraph
   
15-5 No entity may elect the fair value option for any of the following financial assets and financial liabilities:
   f. Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders’ equity (including temporary equity) (for example, a convertible debt instrument within the scope of the Cash Conversion Subsections of Subtopic 470-20 or a convertible debt security with a noncontingent beneficial conversion feature).

On specified election dates (such as when an entity first recognizes an item or when it undergoes a business combination or upon a significant modification of debt as defined in ASC 470-50), ASC 825-10 permits an entity to irrevocably elect to measure an eligible item at fair value (“the fair value option”). An example of an eligible item is a recognized financial liability (such as convertible debt) that is not otherwise excluded from the scope of ASC 825-10 (see the next paragraph). An entity that has elected
the fair value option for a financial liability recognizes (1) the portion of the change in the liability's fair value that is attributable to a change in instrument-specific credit risk in other comprehensive income and (2) the remaining change in the liability's fair value in net income. Upon derecognition, the cumulative amount recognized in other comprehensive income is included in net income.

Under ASC 825-10-15-5(f), “[f]inancial instruments that are, in whole or in part, classified by the issuer as a component of shareholders’ equity” are excluded from the scope of the fair value option in ASC 825-10. Because ASC 470-20 requires the issuer of certain types of convertible debt instruments to separate them into liability and equity components at issuance (e.g., instruments with CCFs or noncontingent BCFs), the issuer cannot elect the fair value option in ASC 825-10 for such instruments. Therefore, an issuer needs to consider whether ASC 470-20 applies to a convertible debt instrument before it can determine whether the fair value option in ASC 825-10 is available (see Section 3.2). Since no part of the instrument is classified in shareholders’ equity at issuance, we believe that election of the fair value option in ASC 825-10 is not precluded for a traditional convertible debt instrument with a contingent BCF (see Section 7.2.4 for further discussion).

In addition to the fair value option in ASC 825-10, ASC 815-15-25-4 provides a fair value option for hybrid financial instruments that otherwise require bifurcation into a host contract and a derivative instrument under ASC 815-15-25-1. Unlike that in ASC 825-10, the fair value option in ASC 815-15 contains no explicit scope exception for financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders’ equity. Therefore, stakeholders have questioned whether an issuer is permitted to elect the fair value option in ASC 815-15 for a convertible debt instrument that (1) has an embedded feature other than the conversion feature (such as a put or call option) that requires bifurcation under ASC 815-15-25-1 and (2) is not eligible for the fair value option in ASC 825-10 because the instrument must be separated into liability and equity components under ASC 470-20 (e.g., it contains a CCF or noncontingent BCF). (If the conversion feature must be bifurcated as an embedded derivative, it is not separated as an equity component under ASC 470-20; see Section 2.3.) Because the fair value option in ASC 825-10 is not available for such a convertible debt instrument (as discussed above), we believe that the issuer also cannot elect the fair value option in ASC 815-15 for the instrument.

2.6 The SEC’s Guidance on Temporary Equity

| ASC 480-10 — SEC Materials — SEC Staff Guidance |
| SEC Staff Announcement: Classification and Measurement of Redeemable Securities S99-3A |

2. ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. As noted in ASR 268, the Commission reasoned that “[t]here is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital.”
SEC Materials — SEC Staff Guidance (continued)

3(e). Convertible debt instruments that contain a separately classified equity component. Other applicable GAAP may require a convertible debt instrument to be separated into a liability component and an equity component. In these situations, the equity-classified component of the convertible debt instrument should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash or other assets (that is, the instrument is currently redeemable or convertible for cash or other assets). For these instruments, an assessment of whether the convertible debt instrument will become redeemable or convertible for cash or other assets at a future date should not be made. For example, a convertible debt instrument that is not redeemable at the balance sheet date but could become redeemable by the holder of the instrument in the future based on the passage of time or upon the occurrence of a contingent event is not considered currently redeemable at the balance sheet date.


12. Initial measurement. The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: . . .

d. For convertible debt instruments that contain a separately classified equity component, an amount should initially be presented in temporary equity only if the instrument is currently redeemable or convertible at the issuance date for cash or other assets (see paragraph 3(e)). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion at the issuance date over (2) the carrying amount of the liability-classified component of the convertible debt instrument at the issuance date.

FN15 ASR 268 does not impact the application of other applicable GAAP to the accounting for the liability component or the accounting upon derecognition of the liability and/or equity component.

16. (Subsequent measurement.) The following additional guidance is relevant to the application of the SEC staff's views in paragraphs 14 and 15: . . .

d. For convertible debt instruments that contain a separately classified equity component, an amount should be presented in temporary equity only if the instrument is currently redeemable or convertible at the balance sheet date for cash or other assets (see paragraph 3(e)). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion at the balance sheet date over (2) the carrying amount of the liability-classified component of the convertible debt instrument at the balance sheet date.

In financial statements filed with the SEC under Regulation S-X, issuers of equity-classified instruments that are redeemable for cash or other assets in circumstances that are not under the issuers' sole control must (1) present such instruments on the face of the balance sheet in a caption that is separate from both liabilities and stockholders' equity (i.e., as “temporary equity”) and (2) apply specific measurement, disclosure, and EPS guidance to them. In addition, an issuer that is subject to the SEC's requirements should consider whether it must classify as temporary equity all or a portion of the equity component of a convertible debt instrument that contains such a component, including each of the following:

- Convertible debt instruments separated into a liability and equity component under the Cash Conversion subsections of ASC 470-20 (i.e., CCF convertible debt instruments; see Chapter 6).
- Convertible debt instruments that contain a separately recognized BCF (see Chapter 7).
• Convertible debt instruments that contain a separately recognized equity component as a result of a previous modification or exchange involving the instrument that (1) was not accounted for as an extinguishment and (2) increased the fair value of the conversion option (see ASC 470-50-40-15 and Section 4.5.6).

• Convertible debt instruments that contain a separately recognized equity component as a result of a reclassification of a previously bifurcated embedded conversion feature (see ASC 815-15-35-4).

Terms and features that could trigger classification as temporary equity are not limited to those that are explicitly described as redemption or put features but also include, for example, certain call, conversion, and liquidation features that could force the issuer to redeem an instrument for cash or assets in circumstances that are not solely within its control.

For convertible debt instruments that contain a separately recognized equity component, ASC 480-10-S99-3A(3)(e) limits the scope of the application of the guidance on temporary equity to scenarios in which the convertible instrument is currently redeemable or convertible by the investor for cash or other assets. Unlike its application to other redeemable equity instruments (e.g., equity-classified redeemable convertible preferred stock with a BCF), the guidance on classifying a convertible debt instrument with a separately recognized equity component as temporary equity must be applied only at the ends of reporting periods in which the instrument is currently redeemable for cash or other assets.\(^3\) Thus, the guidance does not need to be applied at the ends of reporting periods in which the instrument will become redeemable or convertible only on a future date. As a result of this guidance, an entity that has an outstanding convertible debt instrument with a separately recognized equity component must assess, in each financial reporting period, whether the equity component (or a portion thereof) must be classified in temporary equity. As indicated in ASC 480-10-S99-3A(12)(d) and ASC 480-10-S99-3A(16)(d), the amount that must be classified in temporary equity is limited to the excess (if any) of "(1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion . . . over (2) the carrying amount of the liability-classified component of the convertible debt instrument" both at initial measurement and on subsequent balance sheet dates.

**Connecting the Dots**
For further discussion of the application of the SEC's guidance on temporary equity, see Chapter 9 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*.

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\(^3\) A convertible debt instrument that is only currently convertible would meet this condition if the issuer does not control the ability to settle the entire conversion value in shares. See Section 9.4.6 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*. 
2.7 Debt Exchangeable Into the Stock of Another Entity

ASC 470-20 — SEC Materials — SEC Staff Guidance

SEC Observer Comment: Debt Exchangeable for the Stock of Another Entity

S99-1 The following is the text of the SEC Observer Comment: Debt Exchangeable for the Stock of Another Entity.

An issue has been discussed involving an enterprise that holds investments in common stock of other enterprises and issues debt securities that permit the holder to acquire a fixed number of shares of such common stock. These types of transactions are commonly affected through the sale of either debt with detachable warrants that can be exchanged for the stock investment or debt without detachable warrants (the debt itself must be exchanged for the stock investment — also referred to as “exchangeable” debt). Those debt issues differ from traditional warrants or convertible instruments because the traditional instruments involve exchanges for the equity securities of the issuer. There have been questions as to whether the exchangeable debt should be treated similar to traditional convertibles as specified in Subtopic 470-20 or whether the transaction requires separate accounting for the exchangeability feature. The SEC staff believes that Subtopic 470-20 does not apply to the accounting for debt that is exchangeable for the stock of another entity and therefore separation of the debt element and exchangeability feature is required.

A debt instrument may contain a feature that requires or permits its exchange into the shares of a third party rather than those of the issuer. For example, the terms of a debt instrument may give the holder the option to require that the issuer deliver a fixed number of shares of a third party's common stock in lieu of repaying the debt's principal amount at maturity. Although from the holder's perspective, the economic characteristics and risks of an investment in such a debt instrument are somewhat similar to those of an investment in convertible debt, the issuer should not analyze the instrument as convertible debt under ASC 470-20 since it is not settled in the issuer's equity shares. Instead, the issuer should apply the SEC guidance above and account for the exchange feature in accordance with ASC 815-15 if the issuer does not elect to account for the debt instrument under the fair value option in ASC 825-10 (see Section 2.5).

In consolidated financial statements, a contract that is exchangeable into a consolidated subsidiary's equity shares is analyzed in a manner similar to a contract that is convertible into the parent's equity shares provided that the subsidiary is a substantive entity (see Section 2.6.1 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity). This is true irrespective of whether the instrument is issued by the parent or subsidiary. Therefore, if a parent issues a debt instrument that is exchangeable into a consolidated subsidiary's equity shares and the subsidiary is a substantive entity, the exchange feature would be analyzed as a conversion feature under ASC 470-20 unless it must be accounted for as a derivative instrument under ASC 815-15 (e.g., if it can be net settled and does not qualify for the scope exception in ASC 815-10-15-74(a) for certain contracts on the entity's own equity).

In the subsidiary's separate financial statements, the parent's equity is not considered part of the subsidiary's equity. Therefore, a debt instrument that is issued by a subsidiary and exchangeable into the parent's equity shares would not be analyzed as a convertible debt instrument under ASC 470-20 in the subsidiary's separate financial statements (see Section 2.6.2 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity). In the parent's consolidated financial statements, however, the same debt instrument would be analyzed as a debt instrument that is convertible into the issuer's equity shares.

Equity shares issued by an equity method investee are not considered part of the entity's own equity. Therefore, debt instruments that are exchangeable into the shares of an equity method investee are not analyzed as convertible debt under ASC 470-20.
2.8 Convertible Debt Instrument Issued to Nonemployees in Share-Based Payment Transactions

**ASC 470-20**

05-12 A convertible instrument that is issued to a nonemployee in exchange for goods or services or a combination of goods or services and cash and may contain a nondetachable conversion option that permits the holder to convert the instrument into the issuer's stock. This Subtopic provides related guidance.

25-17 The guidance in the following paragraph and paragraph 470-20-25-19 addresses a convertible instrument that is issued or granted to a nonemployee in exchange for goods or services or a combination of goods or services and cash. The convertible instrument contains a nondetachable conversion option that permits the holder to convert the instrument into the issuer's stock.

25-18 Once the instrument is considered issued for accounting purposes pursuant to Subtopic 718-10, distributions paid or payable shall be characterized as financing costs (that is, interest expense or dividends). Before that time, distributions paid or payable under the instrument shall be characterized as a cost of the underlying goods or services.

25-19 If the convertible instrument is issued for cash proceeds that indicate that the instrument includes a beneficial conversion feature and the purchaser of the instrument also provides (receives) goods or services to (from) the issuer that are the subject of a separate contract, the convertible instrument shall be recognized with a corresponding increase or decrease in the purchase or sales price of the goods or services.

30-22 To determine the fair value of a convertible instrument granted as part of a share-based payment transaction to a nonemployee in exchange for goods or services that is equity in form or, if debt in form, that can be converted into equity instruments of the issuer, the entity shall first apply Topic 718 on stock compensation.

**Pending Content (Transition Guidance: ASC 718-10-65-15)**

30-22 To determine the fair value of a convertible instrument granted as part of a share-based payment transaction to a nonemployee in exchange for goods or services or as consideration payable to a customer that is equity in form or, if debt in form, that can be converted into equity instruments of the issuer, the entity shall first apply Topic 718 on stock compensation.

**ASC 718-10**

35-9A A convertible instrument award granted to a nonemployee in exchange for goods or services to be used or consumed in a grantor's own operations is subject to recognition and measurement guidance in this Topic until the award is fully vested. Once vested, a convertible instrument award that is equity in form, or debt in form, that can be converted into equity instruments of the grantor, shall follow recognition and measurement through reference to other applicable generally accepted accounting principles (GAAP), including Subtopic 470-20 on debt with conversion and other options.

ASC 718, as amended by ASU 2018-07, generally aligns the issuer's accounting for share-based payments granted to employees and nonemployees, including the classification of employee and nonemployee awards. Accordingly, such awards generally remain within the scope of ASC 718 throughout their lives provided that they are not modified after they are issued to grantees. However, ASC 718-10-35-9A provides an exception that specifies that convertible debt instruments granted to nonemployees in a share-based payment transaction become subject to other GAAP for financial instruments once vesting has occurred.
After the vesting of convertible debt instruments that were originally granted or issued to nonemployees for goods or services, or as consideration payable to a customer (for entities that have adopted ASU 2019-08), such instruments become subject to the guidance in ASC 470-20 that applies to CCFs and to the evaluation of BCFs in convertible debt instruments that are not subject to the CCF guidance unless the embedded conversion option is bifurcated as an embedded derivative under ASC 815-15 (see Section 2.3). ASC 470-20 contains special guidance on the recognition and measurement of BCFs for convertible debt instruments that became subject to other GAAP for financial instruments (see Section 7.3.5). Any interest that is paid or payable on such instruments is treated as a cost of the underlying goods or services received or receivable (rather than a financing cost) until the instruments are considered issued for accounting purposes. Under ASC 505-50-S99-1, “if the issuer receives a right to receive future services in exchange for unvested, forfeitable equity instruments, those equity instruments should be treated as unissued for accounting purposes until the future services are received (that is, the instruments are not considered issued until they vest).” By analogy to this guidance, convertible debt instruments granted to nonemployees in exchange for goods and services should be treated as unissued for accounting purposes until those goods or services have been received.

ASC 470-20-30-23 through 30-26 contain guidance on the treatment of proceeds in the measurement of any initial BCF in convertible debt instruments issued to nonemployees for goods and services. Although discussed in the context of BCF accounting, that guidance also addresses the initial fair value measurement of the convertible debt instruments, which may be relevant once the instruments become subject to other GAAP for financial instruments, including ASC 470-20 (see further discussion in Section 7.3.5).

### Connecting the Dots

Paragraphs BC22 and BC23 of ASU 2018-07 explain the FASB’s rationale for retaining the existing requirement under which convertible debt instruments issued to nonemployees in share-based payment transactions become subject to other GAAP for financial instruments once vesting has occurred (i.e., performance has been completed):

**BC22.** Notwithstanding the conclusion explained in paragraph BC21, the amendments in this Update require that an entity apply other applicable GAAP (including Subtopic 470-20, Debt — Debt with Conversion and Other Options) to account for a convertible instrument award when it becomes fully vested. For the purposes of applying beneficial conversion feature guidance, this Update amends Subtopic 470-20 to require that an entity use the fair value determined in accordance with Topic 718 as of the date that a convertible instrument award becomes fully vested. Under existing GAAP, convertible instrument awards also require a reassessment under other Topics when the award vests as described in paragraph BC20. Existing GAAP also requires an entity to use the fair value as of the measurement date in accordance with Subtopic 505-50, which is generally when the convertible instrument award vests.

**BC23.** The Board received feedback indicating that convertible instruments granted in exchange for goods or services (convertible instrument awards) rarely occur in practice. As such, the Board decided to preserve the current accounting result for convertible instrument awards rather than delay the issuance of this Update by having to deliberate the accounting for convertible instrument awards. The Board also noted that its current project on distinguishing liabilities from equity (including convertible debt) is better suited to address concerns, if any, with the current accounting model for convertible instrument awards.

### Changing Lanes

The FASB has tentatively decided to amend the guidance that currently requires convertible instruments granted to nonemployees in a share-based payment transaction to become subject to the guidance in ASC 470-20 once the award is fully vested. Under the proposed guidance, convertible instruments granted to nonemployees in a share-based payment transaction would remain within the scope of ASC 718 after vesting. However, a convertible instrument could still become subject to the guidance in ASC 470-20 and other applicable GAAP relevant to financial...
instruments if (1) the instrument is modified after vesting and (2) the nonemployee is no longer providing goods or services or is no longer a customer (see ASC 718-10-35-10). See Chapter 1 for further information on the Board’s proposal to simplify the accounting for certain financial instruments with characteristics of liabilities and equity.

In November 2019, the FASB issued ASU 2019-08 to clarify that an entity should apply ASC 718 to determine the fair value of convertible instruments issued as consideration to a customer. See Appendix C of Deloitte’s A Roadmap to Accounting for Share-Based Payment Awards for information about ASU 2019-08.
Chapter 3 — Contract Analysis

3.1 Overview
Because U.S. GAAP contain several disparate sets of accounting requirements that might apply to a convertible debt instrument, an issuer can save time by organizing its accounting analysis into a framework that is broadly consistent with the order of precedence among those sets of requirements (see Section 3.2 below). The issuer’s accounting analysis should include a careful evaluation of an instrument’s contractual terms (see Section 3.3) and an assessment of whether a transaction comprises multiple freestanding financial instruments or should be combined with other items (see Section 3.4). Further, an issuer may be required to allocate the transaction amount among multiple freestanding financial instruments before applying any specific classification and measurement approach to a convertible debt instrument (see Section 3.5).

3.2 Framework for the Issuer’s Accounting Analysis
This section illustrates how an issuer may organize its accounting analysis into a sequential framework that is broadly consistent with the order of precedence among the different sets of accounting requirements that might apply to a convertible debt instrument. For example, an issuer can save time by evaluating whether the equity conversion feature is required to be bifurcated as a derivative under ASC 815-15 before considering whether the CCF or BCF guidance in ASC 470-20 applies, since the CCF or BCF guidance does not apply if the equity conversion feature must be bifurcated as an embedded derivative. Regardless of the order in which the different sets of requirements are considered, the ultimate accounting conclusions should not differ.

For debt that is convertible into the issuer’s equity shares (or equity that is convertible into an issuer’s equity shares and is required to be classified as a liability), an issuer may perform the following sequence of steps to determine the appropriate accounting for the instrument at inception:

<table>
<thead>
<tr>
<th>Step</th>
<th>Accounting Issues</th>
<th>Deloitte Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Identify each freestanding financial instrument</td>
<td>Does the transaction represent (1) a freestanding financial instrument (e.g., convertible debt), (2) a bundle of freestanding financial instruments (e.g., debt with detachable warrants), or (3) a component of a larger freestanding financial instrument (e.g., a debt contract that is analyzed on a combined basis with a warrant)?</td>
<td>Section 3.4 of this Roadmap as well as Section 3.3 of A Roadmap to Distinguishing Liabilities From Equity and Section 3.2 of A Roadmap to Accounting for Contracts on an Entity’s Own Equity</td>
</tr>
<tr>
<td>Step</td>
<td>Accounting Issues</td>
<td>Deloitte Guidance</td>
</tr>
<tr>
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</tr>
<tr>
<td>2. Allocate the transaction amount among freestanding financial instruments and any other transaction elements</td>
<td>If the transaction represents a bundle of freestanding financial instruments or other elements (see step 1 above), how should the proceeds and issuance costs be allocated among the convertible debt and the other items included in the transaction?</td>
<td>Section 3.5</td>
</tr>
<tr>
<td>3. Determine whether the embedded equity conversion feature is required to be bifurcated as an embedded derivative</td>
<td>Does the embedded equity conversion feature require bifurcation as an embedded derivative under ASC 815-15? (If so, steps 5, 6, 7, 8, and 9 below are not applicable to the feature, but the issuer should consider steps 4, 10, and 13.)</td>
<td>Sections 2.3 and 2.4 and Appendix A of this Roadmap and Chapters 2, 4, and 5 of <em>A Roadmap to Accounting for Contracts on an Entity’s Own Equity</em></td>
</tr>
<tr>
<td>4. Determine whether the convertible debt contains any other features that require bifurcation as embedded derivatives</td>
<td>Other than the equity conversion feature, does any feature embedded in the convertible debt (e.g., a put, call, redemption, or indexation provision) require bifurcation as an embedded derivative under ASC 815-15?</td>
<td>Sections 2.3 and 2.4 and Appendix A</td>
</tr>
<tr>
<td>5. Determine whether the instrument contains a CCF that requires the instrument to be separated into liability and equity components</td>
<td>Is the instrument required to be separated into liability and equity components under the CCF guidance in ASC 470-20? (If so, steps 6, 7, 8, 9, and 10 below do not apply to the instrument.)</td>
<td>Chapter 6</td>
</tr>
<tr>
<td>6. For convertible debt instruments without a CCF, determine whether a BCF should be presented in equity</td>
<td>Does the convertible debt contain a noncontingent BCF that is required to be separately recognized in equity at inception under the BCF guidance in ASC 470-20? (If so, steps 8, 9, and 10 below do not apply to the instrument.)</td>
<td>Chapter 7</td>
</tr>
<tr>
<td>7. For convertible debt instruments without a CCF, determine whether the instrument contains a contingent BCF</td>
<td>Does the convertible debt contain a contingent BCF that will need to be monitored for potential recognition in equity under the BCF guidance in ASC 470-20 if the contingency is triggered?</td>
<td>Section 7.5</td>
</tr>
<tr>
<td>8. For convertible debt instruments without a CCF or BCF, determine whether an in-substance premium should be presented in equity</td>
<td>Was the convertible debt issued at a substantial premium that should be presented in equity under ASC 470-20? (If so, steps 9 and 10 below do not apply.)</td>
<td>Chapter 5</td>
</tr>
<tr>
<td>9. For convertible debt instruments without a CCF or BCF or in-substance premium presented in equity, apply the accounting guidance for traditional convertible debt</td>
<td>Should the convertible debt be accounted for as traditional convertible debt (i.e., as a liability in its entirety) under ASC 470-20?</td>
<td>Chapter 4</td>
</tr>
</tbody>
</table>
### 3.3 Identifying and Evaluating Contractual Terms

When determining the appropriate accounting for a convertible debt instrument, an entity should devote adequate time to reading the underlying legal documents. Terms that could be significant to the accounting analysis may be buried deep within a contract’s fine print. To properly apply the appropriate accounting requirements, the entity needs to evaluate all the contractual terms, the legal and regulatory framework, and the relevant facts and circumstances.
In forming a view on the appropriate accounting, an entity cannot necessarily rely on the name given to the transaction or how it is described in summary term sheets, slideshow presentations, and marketing materials. Products with similar economics sometimes go by different names in the marketplace (e.g., products marketed by different banks), while products subject to different accounting may go by the same or similar names (e.g., the applicability of the CCF guidance in ASC 470-20 to a convertible debt instrument with a CCF depends on whether the equity conversion feature must be separated as an embedded derivative under ASC 815-15). Furthermore, the names given to contractual provisions in legal documents (e.g., conversion, exchange, share settlement, or redemption provisions) do not necessarily reflect their economics or how they would be identified and analyzed for accounting purposes (see, e.g., Sections 2.3 and 2.4 and Appendix A). Minor variations in the way contractual terms are defined can have major accounting implications.

### 3.4 Unit of Account

#### 3.4.1 Overview

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
<th>Unit of Account</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The level at which an asset or a liability is aggregated or disaggregated in a Topic for recognition purposes.</td>
</tr>
</tbody>
</table>

When applying ASC 470-20, an entity should consider how to appropriately identify units of account (i.e., the “level at which an asset or liability is aggregated or disaggregated” for accounting purposes, as defined above). While a single convertible instrument may represent a unit of account, this is not always the case. To determine the appropriate units of account, the issuer should identify freestanding financial instruments (see Section 3.4.2 below) and any components or features that should be accounted for separately, such as certain registration payment arrangements (see Section 3.4.3), equity components (see Chapters 5, 6, and 7), and embedded derivatives (see Section 2.3).

#### 3.4.2 Freestanding Financial Instruments

##### 3.4.2.1 Overview

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
<th>Convertible Security</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Freestanding Financial Instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A financial instrument that meets either of the following conditions:</td>
</tr>
<tr>
<td></td>
<td>a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.</td>
</tr>
<tr>
<td></td>
<td>b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.</td>
</tr>
</tbody>
</table>

Sometimes, a single legal agreement or transaction consists of two or more components that each represent a freestanding financial instrument that should be analyzed separately under ASC 470-20 and other GAAP. For example, an agreement that is described as convertible debt might for accounting purposes need to be analyzed as a debt instrument with a separate, detachable warrant if the warrant is
legally detachable and separately exercisable from the debt. Conversely, two separate agreements might represent a single freestanding financial instrument that should be accounted for as convertible debt under ASC 470-20. For example, if a debt instrument is issued contemporaneously with a warrant to the same counterparty, the issuing entity must account for them on a combined basis as a convertible debt instrument if the warrant is not legally detachable and separately exercisable from the debt instrument (see ASC 470-20-25-3 and Section 3.4.2.3).

ASC 470-20 contains limited guidance on the issuer's identification of freestanding financial instruments in transactions involving convertible debt (see Section 3.4.2.2 below) and debt issued with warrants (see Section 3.4.2.3). In identifying such instruments under ASC 470-20, the issuer should also consider the definitions of a freestanding financial instrument in ASC 480-10 and a freestanding contract in ASC 815-40 (which is substantially equivalent to the definition of a freestanding financial instrument in ASC 480-10) as well as other relevant guidance (e.g., the embedded derivative and combination guidance in ASC 815).

Connecting the Dots
For additional discussion of how to identify freestanding financial instruments, see Section 3.3 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity and Section 3.2 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity.

### 3.4.2.2 Convertible Debt Instruments

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-4</strong> A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore, the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he forgoes the right to redemption, and vice versa.</td>
</tr>
<tr>
<td><strong>05-5</strong> Convertible debt may offer advantages to both the issuer and the purchaser. From the point of view of the issuer, convertible debt has a lower interest rate than does nonconvertible debt. Furthermore, the issuer of convertible debt securities, in planning its long-range financing, may view convertible debt as essentially a means of raising equity capital. Thus, if the fair value of the underlying common stock increases sufficiently in the future, the issuer can force conversion of the convertible debt into common stock by calling the issue for redemption. Under these market conditions, the issuer can effectively terminate the conversion option and eliminate the debt. If the fair value of the stock does not increase sufficiently to result in conversion of the debt, the issuer will have received the benefit of the cash proceeds to the scheduled maturity dates at a relatively low cash interest cost.</td>
</tr>
<tr>
<td><strong>05-6</strong> On the other hand, the purchaser obtains an option to receive either the face or redemption amount of the security or the number of common shares into which the security is convertible. If the fair value of the underlying common stock increases above the conversion price, the purchaser (either through conversion or through holding the convertible debt containing the conversion option) benefits through appreciation. The purchaser may at that time require the issuance of the common stock at a price lower than the fair value. However, should the fair value of the underlying common stock not increase in the future, the purchaser has the protection of a debt security. Thus, in the absence of default by the issuer, the purchaser would receive the principal and interest if the conversion option is not exercised.</td>
</tr>
</tbody>
</table>

A debt instrument that is convertible into the issuer's equity shares should be analyzed as a single freestanding financial instrument (rather than two separate freestanding financial instruments) if the holder's alternative choices of (1) converting the debt into stock or (2) receiving a repayment of the debt are mutually exclusive and cannot exist independently of one another. The choices are mutually
exclusive if the holder cannot both convert the debt into stock and redeem the debt for cash. Further, the choices cannot exist independently of each other if they cannot be sold separately.

**Connecting the Dots**

Although a convertible debt instrument is analyzed for accounting purposes as a single freestanding financial instrument (rather than two separate freestanding financial instruments), an entity may be required for recognition and measurement purposes to separate it into multiple components. For example, ASC 815-15 may require an embedded derivative to be separated from a convertible debt instrument and accounted for as a derivative asset or liability (see Section 2.3), and the Cash Conversion subsections of ASC 470-20 may require separation of a convertible debt instrument into liability and equity components (see Section 6.3.1). The fact that an entity separates such instruments for recognition purposes does not necessarily mean it would do so for balance sheet presentation purposes (see Section 2.3).

### 3.4.2.3 Debt Instruments Issued With Warrants

**ASC 470-20**

05-2 Unlike convertible debt, debt with detachable warrants (detachable call options) to purchase stock is usually issued with the expectation that the debt will be repaid when it matures. The provisions of the debt agreement are usually more restrictive on the issuer and more protective of the investor than those for convertible debt. The terms of the warrants are influenced by the desire for a successful debt financing. Detachable warrants often trade separately from the debt instrument. Thus, the two elements of the security exist independently and may be treated as separate securities.

05-3 From the point of view of the issuer, the sale of a debt security with warrants results in a lower cash interest cost than would otherwise be possible or permits financing not otherwise practicable. The issuer usually cannot force the holders of the warrants to exercise them and purchase the stock. The issuer may, however, be required to issue shares of stock at some future date at a price lower than the market price existing at that time, as is true in the case of the conversion option of convertible debt. Under different conditions the warrants may expire without exercise. The outcome of the warrant feature thus cannot be determined at time of issuance. In either case the debt must generally be paid at maturity or earlier redemption date whether or not the warrants are exercised.

25-3 . . . If stock purchase warrants are not detachable from the debt instrument and the debt instrument must be surrendered to exercise the warrant, the two instruments taken together are substantially equivalent to a convertible debt instrument . . . .

As indicated in ASC 470-20-05-2 and 05-3, a transaction that includes the issuance of both a debt instrument and a warrant on the issuer's equity shares should be treated as if it contains two separate freestanding financial instruments provided that both of the following apply:

- The “warrants . . . trade separately from the debt instrument.”
- The “warrants may expire without exercise,” whereas “the debt must . . . be paid at maturity or [an] earlier redemption date whether or not the warrants are exercised.”

Satisfying these two conditions is considered equivalent to meeting condition (b) in the ASC master glossary definition of a freestanding financial instrument (see Section 3.4.2.1).

Conversely, in accordance with ASC 470-20-25-3, if a warrant on an issuer's equity shares is not detachable from a debt instrument and the warrant cannot be exercised unless the debt is surrendered, the debt and warrant are treated as a single combined freestanding financial instrument since they “are substantially equivalent to a convertible debt instrument” (see also Section 4.5.2.3).
3.4.3 Registration Payment Arrangements

### ASC Master Glossary

**Registration Payment Arrangement**

An arrangement with both of the following characteristics:

a. It specifies that the issuer will endeavor to do either of the following:
   1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S. Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period
   2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).

b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).

### ASC 825-20

15-4 The guidance in this Subtopic does not apply to any of the following:

a. Arrangements that require registration or listing of convertible debt instruments or convertible preferred stock if the form of consideration that would be transferred to the counterparty is an adjustment to the conversion ratio. (Subtopic 470-20 provides guidance on accounting for convertible instruments with contingently adjustable conversion ratios.)

b. Arrangements in which the amount of consideration transferred is determined by reference to either of the following:
   1. An observable market other than the market for the issuer’s stock
   2. An observable index.
   
   For example, if the consideration to be transferred if the issuer is unable to obtain an effective registration statement is determined by reference to the price of a commodity. See Subtopic 815-15 for related guidance.

   c. Arrangements in which the financial instrument or instruments subject to the arrangement are settled when the consideration is transferred (for example, a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares that are issuable upon exercise of the warrant is not declared effective by the SEC within a specified grace period).

25-1 An entity shall recognize a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.

25-2 The financial instrument(s) subject to the registration payment arrangement shall be recognized in accordance with other applicable generally accepted accounting principles (GAAP) (for example, Subtopics 815-10; 815-40; and 835-30) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

30-1 An entity shall measure a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.
The financial instrument(s) subject to the registration payment arrangement shall be measured in accordance with other applicable generally accepted accounting principles (GAAP) (for example, Subtopics 815-10; 815-40; and 835-30) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

ASC 825-20 contains special unit-of-account guidance on registration payment arrangements. When issuing a convertible debt instrument, an issuer may agree to pay specified amounts if it is unable to deliver registered shares or maintain an effective registration. For example, a convertible debt instrument may require the issuer to:

- Use its “best efforts” to file a registration statement for the resale of shares and have the registration statement declared effective by the end of a specified grace period (e.g., within 90 to 180 days).
- Maintain the effectiveness of a registration statement for a period.

If the issuer fails to meet these conditions, the contract may require it to make cash payments to the counterparty unless and until a registration statement is declared effective. For example, the contract may require that after the 180-day grace period, the entity must pay the investor 2 percent of the contract purchase price for each month in which there is no registration statement in effect that covers the shares that will be delivered under the contract.

A registration payment arrangement that meets the ASC master glossary definition thereof is treated as a unit of account that is separate from the related convertible instrument even if the registration payment arrangement is included in the terms of the convertible debt instrument. However, payment arrangements that do not meet the definition of a registration payment arrangement are not within the scope of the ASC 825-20 guidance on registration payment arrangements; ASC 825-20-15-5 specifically states that the guidance in ASC 825-20 “shall not be applied by analogy to the accounting for contracts that are not registration payment arrangements” under ASC 825-20.

A registration payment arrangement that is within the scope of ASC 825-20 is treated as a contingent liability (see ASC 825-20-30-3). This means that proceeds from the related financing transaction are allocated to the registration payment arrangement upon initial recognition only if there is a probable obligation to make payments under the arrangement that can be reasonably estimated (see ASC 825-20-30-4). If the obligation becomes probable and can be reasonably estimated after inception, a contingent liability is then recognized, with an offset to earnings. Any subsequent change in the amount of the contingent liability is also recognized in earnings (see ASC 825-20-35-1). If the entity is required to deliver shares under the arrangement, the number of shares can be reasonably estimated, and the transfer is probable, the entity measures the contingent liability by using the issuer's stock price as of the reporting date (see ASC 825-20-30-5).

An arrangement would not be accounted for as a separate unit of account under ASC 825-20 if it contains any of the following provisions:

- The form of consideration transferred is a contingently adjustable conversion ratio in a convertible instrument.
- The payment is adjusted by reference either to an observable market other than the issuer's stock (e.g., a commodity price) or to an observable index.
- The payment is made when the contract subject to the arrangement is settled (e.g., a payment that is made upon the exercise of an option on own stock that is subject to the arrangement).
Accordingly, an entity would consider such provisions in its analysis of the convertible instrument under ASC 470-20, including the assessment of whether the equity conversion feature must be bifurcated as a derivative instrument under ASC 815-10.

**Connecting the Dots**
Some convertible debt instruments issued in accordance with an exemption from registration under the Securities Act of 1933 contain provisions that require the issuing entity to pay additional interest at a specified time after the issuance date if (1) the convertible debt instrument is not freely tradable by its holders or (2) the issuer has not timely filed any report or document that must be filed with the SEC under Section 13 or 15(d) of the Exchange Act of 1934. Because these payment provisions do not pertain to the filing or maintenance of either an effective registration statement or an exchange listing, they do not meet the definition of a registration payment arrangement. While such payment provisions may be attributed to the hybrid debt contract and therefore may not affect the classification of the embedded conversion option as equity under ASC 815-40 (see Section 3.2.4 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*), they must be separately evaluated as embedded derivative features under ASC 815-15. In practice, such features generally are bifurcated from the host contract, although they may have minimal fair value.

**3.5 Allocation of Proceeds and Issuance Costs**

**3.5.1 Overview**
This section discusses how an issuer should allocate proceeds (see Section 3.5.2 below) and issuance costs (see Section 3.5.3) among freestanding financial instruments when those instruments are issued in a single transaction as well as the guidance in ASC 470-20 on the issuer’s allocation of proceeds between debt and detachable warrants (see Section 3.5.2.3.1). The allocation of such amounts to components or features contained in a freestanding convertible instrument is briefly addressed in Section 3.5.4.

**3.5.2 Allocation of Proceeds**

**3.5.2.1 Overview**
The amount of proceeds attributable to a financial instrument affects the determination of its initial carrying amount. ASC 835-30-25-4 specifies that if a debt instrument is issued solely for cash and the transaction does not involve any other stated or unstated rights or privileges, its present value at initial recognition is presumed to equal the amount of cash proceeds received from the investor. As indicated in ASC 820-10-30-3, if a financial instrument is measured at fair value upon initial recognition (e.g., derivative instruments and financial liabilities for which the issuer has elected the fair value option in ASC 825-10), “[i]n many cases, the transaction price [such as cash proceeds received] will equal the fair value,” although not always (see also ASC 820-10-30-3A for further guidance).

Generally, one of the following two approaches applies to the issuer’s allocation of proceeds received among freestanding financial instruments that are part of the same transaction:

- A with-and-without method (also known as a residual method; see Section 3.5.2.2).
- A relative fair value method (see Section 3.5.2.3).
The appropriate allocation method depends on the accounting that applies to each freestanding financial instrument issued as part of the transaction. The issuer should also consider whether it is necessary to allocate an amount to any other rights or privileges included in the transaction (see Section 3.5.2.4). In addition, note that proceeds must be allocated among freestanding financial instruments before any amounts can be allocated to component parts of a freestanding financial instrument such as a convertible debt instrument (e.g., to an equity component that is separately recognized under ASC 470-20 or an embedded derivative instrument that is bifurcated under ASC 815-15; see Section 3.5.4).\(^1\)

### 3.5.2.2 With-and-Without Method

If one or more, but not all, of the freestanding financial instruments issued as part of a single transaction must be recognized as assets or liabilities measured at fair value on a recurring basis (e.g., one of the instruments is accounted for as a derivative instrument under ASC 815 or at fair value under the fair value option in ASC 825-10), the with-and-without method should be applied in the allocation of proceeds among the freestanding financial instruments. This approach is analogous to the allocation method for bifurcated embedded derivatives in ASC 815-15-30-2 and 30-3.

Under the with-and-without method, a portion of the proceeds equal to the fair value of the instrument (or instruments) measured at fair value on a recurring basis is first allocated to that instrument (or instruments) on the basis of its fair value as of the initial measurement date. The remaining proceeds are then allocated to the other instrument (or instruments) issued in the same transaction either on a residual basis, if there is only one remaining instrument, or by using a relative fair value approach, if there are multiple remaining instruments. The with-and-without allocation approach avoids the recognition of a “day one” gain or loss in earnings that is not associated with a change in the fair value of the instrument (or instruments) that is subsequently measured at its fair value. Under this approach, if there is only one freestanding financial instrument to which the residual proceeds are allocated, the issuer is not required to estimate that instrument's fair value.

#### Example 3-1

**Debt Issued With Liability-Classified Warrants**

Company C issues debt to Company B, together with a detachable and separately transferable warrant, for total proceeds of $10,000, which is also the par amount of the debt. The warrant gives the holder the right to purchase shares issued by C, which are redeemable for cash at the holder's option. Company C determines that the debt and the warrant represent separate freestanding financial instruments.

Rather than electing to account for the debt by using the fair value option in ASC 825-10, C will account for it by using the interest method in ASC 835-30. In evaluating whether the warrant is within the scope of ASC 480-10, C determines that the warrant is a freestanding financial instrument that embodies an obligation to repurchase the issuer’s equity shares and may require the issuer to settle the obligation by transferring assets. In a manner consistent with the guidance in ASC 480-10, C will account for the warrant as a liability that is measured both initially and subsequently at fair value, with changes in fair value recognized in earnings (see Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*). Company C estimates that the initial fair value of the warrant is $2,000.

In determining the initial carrying amounts, C allocates the proceeds received between the debt and the warrant. Because the warrant, but not the debt, will be measured at fair value, with changes in fair value recognized in earnings, C should first measure the fair value of the warrant ($2,000) and allocate that amount to the warrant liability. The amount of proceeds allocated to the debt is the difference between the total proceeds received ($10,000) and the fair value of the warrant ($2,000). The resulting discount from the par amount of the debt ($2,000) is accreted to par by using the effective-interest method in ASC 835-30.

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\(^1\) After applying the appropriate method for allocating proceeds among multiple freestanding financial instruments, an entity would evaluate whether any of those instruments contain embedded derivatives that require separation under ASC 815-15. The separation of an embedded derivative from its host contract is performed by using the with-and-without method as described in ASC 815-15-30-2 and 30-3.
3.5.2.2.1 Estimated Fair Values Exceed Proceeds Received

In some circumstances, the initial fair value of the items that must be subsequently measured at fair value exceeds the proceeds received. At the 2014 AICPA Conference on Current SEC and PCAOB Developments, then SEC Office of the Chief Accountant (OCA) Professional Accounting Fellow Hillary Salo addressed the allocation of proceeds related to the issuance of a hybrid instrument in situations in which the initial fair value of the financial liabilities that must be measured at fair value (such as embedded derivatives) exceeds the net proceeds received. She provided an example in which “a reporting entity that wants to align itself with a specific investor issues $10 million of convertible debt at par and is required to bifurcate an in the money conversion option with a fair value of $12 million.” We believe that her remarks are applicable by analogy to freestanding financial instruments (e.g., debt issued with detachable warrants) when (1) one or both are measured at fair value with changes in fair value recognized in earnings and (2) the initial fair value of items that must be remeasured at fair value exceeds the amount of the proceeds received.

Example 3-2

**Debt With Detachable Warrants**

Entity Y issues debt and detachable warrants for $100 million of cash proceeds. The entity elects to account for the debt at fair value under the fair value option in ASC 825-10. In accordance with ASC 815, Y must account for the warrants as derivatives at fair value. The total estimated fair value of the debt and the warrants is $120 million as of the issuance date.

Ms. Salo made the following remarks:

> [T]he staff believes that when reporting entities analyze these types of unique fact patterns, they should first, and most importantly, verify that the fair values of the financial liabilities required to be measured at fair value are appropriate under Topic 820. [Footnote omitted] If appropriate, then the reporting entity should evaluate whether the transaction was conducted on an arm's length basis, including an assessment as to whether the parties involved are related parties under Topic 850. [Footnote omitted] Lastly, if at arm's length between unrelated parties, a reporting entity should evaluate all elements of the transaction to determine if there are any other rights or privileges received that meet the definition of an asset under other applicable guidance.

In the fact patterns analyzed by the staff, we concluded that if no other rights or privileges that require separate accounting recognition as an asset could be identified, the financial liabilities that are required to be measured at fair value (for example, embedded derivatives) should be recorded at fair value with the excess of the fair value over the net proceeds received recognized as a loss in earnings. Furthermore, given the unique nature of these transactions, we would expect reporting entities to provide clear and robust disclosure of the nature of the transaction, including reasons why the entity entered into the transaction and the benefits received.

Additionally, some people may wonder whether the staff would reach a similar conclusion if a transaction was not at arm's length or was entered into with a related party. We believe those fact patterns require significant judgment; therefore, we would encourage consultation with OCA in those circumstances.

Accordingly, an entity should perform the following steps in determining the appropriate accounting (unless otherwise noted, the quoted text is from Ms. Salo's speech):

- **Step 1** — “[V]erify that the fair values of the financial liabilities required to be measured at fair value are appropriate under Topic 820.”

If the entity has not complied with the fair value measurement requirements in ASC 820 regarding its estimated values, it should adjust those values to ensure its compliance. For a detailed discussion of the requirements in ASC 820, see Deloitte’s *A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option).*
• Step 2 — “[E]valuate whether the transaction was conducted on an arm’s length basis, including an assessment as to whether the parties involved are related parties under Topic 850.”

As noted in ASC 820-10-35-2, a “fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions.” ASC 820-10-20 defines market participants, in part, as parties that are independent of each other (i.e., not related parties). A transaction price may not represent fair value if, for example, (1) the transaction was between related parties or took place under duress or (2) the entity was forced to accept the transaction price because of financial difficulties.

In practice, a pro rata distribution to equity owners is recognized as an equity transaction (i.e., as a deemed dividend with a debit to retained earnings or other applicable equity account), whereas a non-pro-rata distribution is recognized as a charge to earnings in the period in which the distribution is declared. Thus, if a wholly owned subsidiary issues debt to its parent, any excess of the fair value of the instruments issued over the proceeds received might represent a deemed dividend from the subsidiary to the parent. If a related-party transaction represents a non-pro-rata distribution, however, expense recognition may be appropriate.

• Step 3 — “[E]valuate all elements of the transaction to determine if there are any other rights or privileges received that meet the definition of an asset under other applicable guidance.”

If the transaction was conducted at arm’s length and the total fair value of the liabilities measured at fair value exceeds the proceeds received, an entity should carefully evaluate whether the difference is attributable to some other transaction element that qualifies for accounting recognition (e.g., separate freestanding financial instruments or other rights or privileges). If so, those elements should be recognized separately (e.g., as an asset or expense in accordance with other applicable GAAP). By analogy, under paragraph 3 of FTB 85-6 (partially codified in ASC 505-30), it is presumed that a purchase of shares at a price significantly in excess of the open market price includes amounts attributable to other items:

A purchase of shares at a price significantly in excess of the current market price creates a presumption that the purchase price includes amounts attributable to items other than the shares purchased. For example, the selling shareholder may agree to abandon certain acquisition plans, forego other planned transactions, settle litigation, settle employment contracts, or restrict voluntarily the ability to purchase shares of the company or its affiliates within a stated time period.

If, after performing these steps, an entity determines that no other transaction elements can be identified, the excess of the fair value over the proceeds is recognized as an expense (an up-front loss). In this circumstance, the SEC staff expects the entity “to provide clear and robust disclosure of the nature of the transaction, including reasons why the entity entered into the transaction and the benefits received.”

3.5.2.3 Relative Fair Value Method

The relative fair value method is appropriate if either of the following applies: (1) none of the freestanding financial instruments issued as part of a single transaction are measured at fair value, with changes in fair value recognized in earnings on a recurring basis, or (2) after the entity measures freestanding financial instruments at fair value under the with-and-without method, more than one freestanding financial instrument is not subsequently measured at fair value on a recurring basis. To apply this method, the entity allocates the proceeds (or remaining proceeds after application of the with-and-without method) on the basis of the fair values of each freestanding financial instrument at the time of issuance. ASC 470-20-25-2 requires an entity to use the relative fair value allocation approach to allocate proceeds in certain transactions involving debt and detachable warrants. The approach is also appropriate for other transactions that involve freestanding financial instruments not measured at fair value on a recurring basis.
Under the relative fair value method, the issuer makes separate estimates of the fair value of each freestanding financial instrument and then allocates the proceeds in proportion to those fair value amounts (e.g., if the estimated fair value of one of the instruments is 20 percent of the sum of the estimated fair values of each of the instruments issued in the transaction, 20 percent of the proceeds would be allocated to that instrument). Because an issuer needs to independently measure each freestanding financial instrument issued as part of the transaction, more fair value estimates are required under the relative fair value method than under the with-and-without method.

In some transactions involving the issuance of more than two freestanding financial instruments, both the with-and-without method and the relative fair value method will apply. For example, if one freestanding financial instrument is measured at fair value on a recurring basis and others are not, the freestanding financial instrument that is subsequently measured at fair value on a recurring basis should be initially measured at its fair value, and the remaining amount of proceeds should be allocated among the freestanding financial instruments not subsequently measured at fair value on the basis of their relative fair values.

After allocating the proceeds to the freestanding financial instruments under the appropriate method or methods, as described above, the entity should separate any component parts from an individual freestanding financial instrument in accordance with applicable GAAP (see Section 3.5.4).

### 3.5.2.3.1 Debt With Detachable Warrants

<table>
<thead>
<tr>
<th>ASC 470-20</th>
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</table>

**25-2** Proceeds from the sale of a debt instrument with stock purchase warrants (detachable call options) shall be allocated to the two elements based on the relative fair values of the debt instrument without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants shall be accounted for as paid-in capital. The remainder of the proceeds shall be allocated to the debt instrument portion of the transaction. This usually results in a discount (or, occasionally, a reduced premium), which shall be accounted for under Topic 835.

**25-3** The same accounting treatment applies to issues of debt instruments (issued with detachable warrants) that may be surrendered in settlement of the exercise price of the warrant. However, if stock purchase warrants are not detachable from the debt instrument and the debt instrument must be surrendered to exercise the warrant, the two instruments taken together are substantially equivalent to a convertible debt instrument and the accounting specified in paragraph 470-20-25-12 shall apply.

**30-1** The allocation of proceeds under paragraph 470-20-25-2 shall be based on the relative fair values of the two instruments at time of issuance. If a commitment date must be identified in accordance with paragraphs 470-20-30-9 through 30-12 for purposes of applying the guidance on beneficial conversion features, that commitment date shall be used also to determine the relative fair values of all instruments issued together with a convertible instrument when allocating the proceeds to the separate instruments pursuant to this paragraph.

**30-2** When detachable warrants (detachable call options) are issued in conjunction with a debt instrument as consideration in purchase transactions, the amounts attributable to each class of instrument issued shall be determined separately, based on values at the time of issuance. The debt discount or premium shall be determined by comparing the value attributed to the debt instrument with the face amount thereof.

When an entity issues debt together with detachable stock purchase warrants that represent separate freestanding financial instruments (see Section 3.4.2), the proceeds received must be allocated between the debt and the warrants. Although ASC 470-20-25-2 may appear to suggest that the relative fair value method should always be applied to debt issued together with detachable warrants, we believe that the scope of this guidance is limited to situations in which the warrants are classified as equity and the debt
is not subsequently measured at fair value on a recurring basis. While ASC 470-20-25-2 suggests that the amounts allocated to detachable warrants should be accounted for as paid-in capital, that guidance conflicts with other GAAP that require entities to classify certain contracts on the entity's own equity as assets or liabilities (e.g., ASC 480-10 and ASC 815).

Before the FASB's codification of U.S. GAAP, the guidance on debt and detachable warrants in ASC 470-20 was contained in APB Opinion 14. When the FASB and EITF subsequently issued guidance on evaluating whether warrants and other contracts on an entity's own equity should be classified as equity or liabilities (e.g., FASB Statement 150 and EITF Issue 00-19), they did not make consequential amendments to APB Opinion 14. However, in practice, it is generally understood and accepted that the guidance in APB Opinion 14 (as codified in ASC 470-20-25-2) on the classification of detachable stock purchase warrants should be interpreted in light of that subsequent guidance. Neither ASC 480-10 nor ASC 815 exempts detachable warrants on the issuer's equity shares from its scope.

The portion of the proceeds allocated to the warrants should therefore be accounted for as paid-in capital only if the warrants qualify for classification as equity under ASC 815-40 and other applicable GAAP. If warrants must be classified as an asset or liability under ASC 480-10 or other GAAP, the amount attributable to the warrants should be accounted for under that other guidance. Accordingly, an entity should not rely solely on the guidance in ASC 470-20-25-2 and 25-3 when classifying detachable warrants as liabilities or equity or when allocating proceeds between debt and detachable warrants.

**Connecting the Dots**

For a discussion of how to determine the appropriate classification and measurement of a detachable warrant, see Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity* and *A Roadmap to Distinguishing Liabilities From Equity*.

The following table provides an overview of the appropriate allocation of proceeds between debt and detachable warrants at initial recognition:

<table>
<thead>
<tr>
<th>Warrant Accounted for at Fair Value With Fair Value Changes Recognized in Earnings</th>
<th>Warrant Classified as Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt accounted for at amortized cost</td>
<td>With-and-without method under which the warrant is measured initially at fair value and the debt is measured as the residual (see Section 3.5.2.2).</td>
</tr>
<tr>
<td>Debt accounted for at fair value, with changes in fair value recognized in earnings</td>
<td>If the estimated fair values exceed the proceeds received, special considerations apply (see Section 3.5.2.2.1). If it is determined that the transaction price does not represent fair value, additional considerations are also necessary. Otherwise, a relative fair value method may be reasonable.</td>
</tr>
</tbody>
</table>
3.5.2.4 Other Transaction Components

The issuer should consider whether U.S. GAAP require allocation of any amount to stated or unstated rights or privileges included in the transaction other than the freestanding financial instruments issued. Although ASC 470-20 explicitly requires entities to evaluate whether this allocation is required only for instruments subject to the CCF guidance (see Section 6.3.5), the guidance applies equally to other instruments within the scope of ASC 470-20. For example, if a company issues a three-year note that pays no interest in exchange for cash equal to the face amount of the note and the holder’s right to purchase products at a below-market price, the company might be required to recognize those rights separately in a manner consistent with the guidance in ASC 835-30-25-6.

3.5.3 Allocation of Issuance Costs

3.5.3.1 Concept of Issuance Costs

Issuance costs are specific incremental costs that are (1) paid to third parties and (2) directly attributable to the issuance of a debt or equity instrument. Thus, issuance costs represent costs incurred with third parties that result directly from and are essential to the financing transaction and would not have been incurred by the issuer had the financing transaction not occurred. Examples of costs that may qualify as issuance costs include underwriting fees, professional fees paid to attorneys and accountants, printing and other document preparation costs, travel costs, and registration and listing fees directly related to the issuance of the instrument. In accordance with ASC 470-20-30-13, however, “[a]ny amounts paid to the investor when the transaction is consummated represent a reduction in the proceeds received by the issuer (not issuance costs).” For example, commitment fees, origination fees, and other amounts paid to the investor (such as reimbursement of the investor’s expenses) represent a reduction of the proceeds, not an issuance cost.²

Costs that would have been incurred irrespective of whether there is a proposed or actual offering do not qualify as issuance costs. For example, in accordance with SAB Topic 5.A (reproduced in ASC 340-10-599-1), allocated management salaries and other general and administrative expenses do not represent an issuance cost. Similarly, legal and accounting fees that would have been incurred irrespective of whether the instrument was issued are not issuance costs (see AICPA Technical Q&As Section 4110.01). Further, the SEC staff believes that if a proposed offering is aborted (including the postponement of an offering for more than 90 days), its associated costs do not represent issuance costs of a subsequent offering.

Unless a debt instrument is subsequently measured at fair value on a recurring basis, any issuance costs attributable to the initial sale of the instrument should be offset against the associated proceeds in the determination of the instrument’s initial net carrying amount (see ASC 835-30-45-1A). Similarly, issuance costs attributable to the initial sale of an equity instrument should be deducted from the related proceeds (see SAB Topic 5.A and AICPA Technical Q&As Section 4110.01). (See Section 3.5.3.2 for a discussion of the allocation of issuance costs to multiple freestanding financial instruments issued as part of the same transaction.)

However, as indicated in ASC 825-10-25-3, if the fair value option has been elected for a debt instrument, “[u]pfront costs and fees [are] recognized in earnings as incurred and not deferred” (see Section 2.5). Any issuance costs allocated to other instruments that are subsequently measured at fair value, with changes in fair value recognized in earnings (e.g., derivative instruments), also are recognized in the period incurred since they are not a characteristic of the asset or liability (see ASC 820-10-35-9B).

² Depending on the relationship between the issuer and the investor, amounts paid to the investor could represent a dividend or other distribution as opposed to an issuance cost. An entity should use judgment and consider the particular facts and circumstances when determining what these amounts represent.
3.5.3.2 Allocation Methods

Entities should consistently apply a systematic and rational method for allocating issuance costs among freestanding financial instruments that form part of the same transaction. In limited circumstances, U.S. GAAP prescribe a specific allocation method for such costs (e.g., for allocating issuance costs between the liability and equity components of instruments subject to the CCF guidance in ASC 470-20; see Section 6.3.4). Otherwise, the allocation method depends on the specific facts and circumstances. If the proceeds are allocated solely on the basis of the relative fair value method, issuance costs should also be allocated on that basis, which is consistent with the guidance in SAB Topic 2.A.6 (reproduced in ASC 340-10-S99-2). We generally believe that if an entity uses the with-and-without method (including allocation to a freestanding financial instrument that contains an embedded derivative that must be bifurcated from its host contract), one of the following two methods is appropriate:

- **The relative fair value method** — The issuer would allocate issuance costs on the basis of the relative fair values of the freestanding financial instruments by analogy to the allocation of proceeds to debt instruments with detachable warrants in ASC 470-20-25-2. SAB Topic 2.A.6 (reproduced in ASC 340-10-S99-2) states that this method should be applied in the allocation of costs between services received “[w]hen an investment banker provides services in connection with a business combination or asset acquisition and also provides underwriting services associated with the issuance of debt or equity securities.” However, if no proceeds are allocated to the debt under the with-and-without method, any issuance costs allocated to the debt under the relative fair value method should be expensed as incurred because it would be inappropriate to present a debt liability as an asset.

- **An approach that is consistent with the allocation of proceeds** — The issuer would allocate issuance costs in proportion to the allocation of proceeds between the freestanding financial instruments (see Section 3.5.2). ASC 470-20-30-31 requires entities to use this approach when allocating issuance costs between the liability and equity components of convertible instruments within the scope of the CCF guidance in ASC 470-20.

The method used should be applied consistently to similar transactions. Any issuance costs allocated to a freestanding or an embedded financial instrument that is subsequently measured at fair value through earnings must be expensed as of the issuance date (see, e.g., ASC 825-10-25-3).

3.5.3.3 Transactions That Involve the Receipt of Noncash Financial Assets

We believe that if an entity issuing debt receives consideration that includes noncash financial assets (e.g., tranche debt financings that include the issuance of debt and the receipt of loan commitments), the related transaction costs (i.e., incremental direct issuance costs) may be allocated in one of two ways:

1. The costs are allocated only to the financial liabilities or equity issued. No costs are allocated to the noncash financial assets received since they form part of the proceeds received, which are allocated to the financial instruments issued.

2. The costs are allocated to both the noncash financial assets received and the financial liabilities or equity issued without regard to whether the fair values are positive or negative (i.e., by using absolute values). Costs and fees are allocated to the noncash financial assets on the basis that transaction costs would have been incurred in a stand-alone transaction for those assets.
Example 3-3

Tranche Debt Financing With Warrants

Entity S enters into a tranche debt financing arrangement with an investment firm. On the initial closing date, S issues to the investment firm a note payable with a principal amount of $30 million and warrants on its own stock. In exchange, S receives cash proceeds of $30 million and a loan commitment under which it may draw up to $200 million of additional notes if certain business milestones are met. In addition, S incurs $3.2 million of third-party costs directly attributable to the financing arrangement.

Entity S determines that the note payable, the warrants, and the loan commitment represent separate units of account. It engages a valuation specialist, who provides the following fair value estimates:

- Note payable — $16,532,595.
- Loan commitment asset — $38,385,821.
- Warrants — $51,853,226.

Entity S does not elect to account for the note payable by using the fair value option in ASC 825-10. Its policy is to allocate issuance costs on a relative fair value basis by analogy to ASC 470-20-25-2 (see Section 3.5.3.2). Accordingly, S can elect to allocate the third-party issuance costs in one of the following two ways:

Allocation Approach 1 — Allocate Third-Party Issuance Costs Only to the Debt and Warrants

Under this approach, an entity allocates the proceeds received, after deducting third-party costs, to the debt and warrants on the basis of their relative fair values. No third-party costs are allocated to the loan commitment asset since that asset forms part of the proceeds received.

Net Proceeds

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross cash received</td>
<td>$30,000,000</td>
</tr>
<tr>
<td>Fair value of loan commitment asset</td>
<td>$38,385,821</td>
</tr>
<tr>
<td>Less: direct issue costs</td>
<td>$(3,200,000)</td>
</tr>
<tr>
<td><strong>Net Proceeds</strong></td>
<td><strong>$65,185,821</strong></td>
</tr>
</tbody>
</table>

Fair Values

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt issued</td>
<td>$16,532,595</td>
<td>24%</td>
</tr>
<tr>
<td>Warrants</td>
<td>$51,853,226</td>
<td>76%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$68,385,821</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Relative Fair Value Allocation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$15,758,980</td>
</tr>
<tr>
<td>Warrants</td>
<td>$49,426,841</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$65,185,821</strong></td>
</tr>
</tbody>
</table>

Allocation of Third-Party Costs

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt issued</td>
<td>$773,615</td>
</tr>
<tr>
<td>Warrants</td>
<td>$2,426,385</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$3,200,000</strong></td>
</tr>
</tbody>
</table>

Components of Fair Value Allocation — Debt

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td>$16,532,595</td>
</tr>
<tr>
<td>Issue costs</td>
<td>$(773,615)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$15,758,980</strong></td>
</tr>
</tbody>
</table>
**Example 3-3 (continued)**

### Components of Fair Value Allocation — Warrants

<table>
<thead>
<tr>
<th>Component</th>
<th>Fair value</th>
<th>($51,853,226)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td></td>
<td>$51,853,226</td>
</tr>
<tr>
<td>Issue costs</td>
<td>$(2,426,385)</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$49,426,841</strong></td>
</tr>
</tbody>
</table>

### Journal Entry — If Warrants Classified in Equity

- **Cash**
  - 26,800,000
- **Debt discount — issue costs**
  - 773,615
- **Debt discount — original issuance**
  - 13,467,405
- **Commitment asset**
  - 38,385,821
  - **Debt — principal amount**
    - 30,000,000
  - **Additional paid-in capital (APIC) — warrants**
    - 49,426,841

### Journal Entry — If Warrants Classified as Liability

- **Cash**
  - 26,800,000
- **Debt discount — issue costs**
  - 773,615
- **Debt discount — original issuance**
  - 13,467,405
- **Commitment asset**
  - 38,385,821
- **Expense — warrants issue costs**
  - 2,426,385
  - **Debt — principal amount**
    - 30,000,000
  - **Liability — warrants**
    - 51,853,226

### Allocation Approach 2 — Allocate Third-Party Issuance Costs to the Debt, the Warrants, and the Loan Commitment Asset

Under this approach, an entity allocates third-party costs to the debt, warrants, and loan commitment asset on the basis of their relative fair values without regard to whether the fair values are positive or negative (i.e., by using absolute values). The allocation of some third-party costs to the loan commitment asset is consistent with the treatment of transaction costs associated with financial assets that are not classified as held for trading (i.e., if only a loan commitment had been obtained, there could have been third-party costs that would be capitalizable).

### Gross Proceeds

<table>
<thead>
<tr>
<th>Gross cash received</th>
<th>$30,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of loan commitment asset</td>
<td>38,385,821</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$68,385,821</strong></td>
</tr>
</tbody>
</table>

### Fair Values

<table>
<thead>
<tr>
<th>Component</th>
<th>Fair value</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt issued</td>
<td>$16,532,595</td>
<td>24%</td>
</tr>
<tr>
<td>Warrants</td>
<td>51,853,226</td>
<td>76%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$68,385,821</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
Example 3-3 (continued)

Relative Fair Value Allocation

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$ 16,532,595</td>
</tr>
<tr>
<td>Warrants</td>
<td>51,853,226</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 68,385,821</strong></td>
</tr>
</tbody>
</table>

Allocation of Third-Party Costs (Absolute Amounts)

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitment asset</td>
<td>$ 38,385,821</td>
<td>36%</td>
</tr>
<tr>
<td>Debt issued</td>
<td>16,532,595</td>
<td>15%</td>
</tr>
<tr>
<td>Warrants</td>
<td>51,853,226</td>
<td>49%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$106,771,642</strong></td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitment asset</td>
<td>$ 1,150,442</td>
</tr>
<tr>
<td>Debt issued</td>
<td>495,490</td>
</tr>
<tr>
<td>Warrants</td>
<td>1,554,068</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 3,200,000</strong></td>
</tr>
</tbody>
</table>

Journal Entry — If Warrants Classified in Equity

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>26,800,000</td>
</tr>
<tr>
<td>Debt discount — issue costs</td>
<td>495,490</td>
</tr>
<tr>
<td>Debt discount — original issuance</td>
<td>13,467,405</td>
</tr>
<tr>
<td>Commitment asset</td>
<td>39,536,263</td>
</tr>
<tr>
<td>Debt — principal amount</td>
<td>30,000,000</td>
</tr>
<tr>
<td>APIC — warrants</td>
<td>50,299,158</td>
</tr>
</tbody>
</table>

Journal Entry — If Warrants Classified as Liability

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>26,800,000</td>
</tr>
<tr>
<td>Debt discount — issue costs</td>
<td>495,490</td>
</tr>
<tr>
<td>Debt discount — original issuance</td>
<td>13,467,405</td>
</tr>
<tr>
<td>Commitment asset</td>
<td>39,536,263</td>
</tr>
<tr>
<td>Expense — warrants issue costs</td>
<td>1,554,068</td>
</tr>
<tr>
<td>Debt — principal amount</td>
<td>30,000,000</td>
</tr>
<tr>
<td>Liability — warrants</td>
<td>51,853,226</td>
</tr>
</tbody>
</table>

Note that to allocate the costs under this approach, an entity determines the relative fair values on the basis of the absolute amounts of the items since it would be inappropriate to allocate negative third-party costs to the loan commitment asset. Because the fair value of the proceeds received equals that of the financial instruments issued, the use of a relative fair value allocation methodology does not affect the allocation of proceeds to the financial instruments issued in this example.
3.5.4 Allocation to Components or Features Contained in a Freestanding Convertible Debt Instrument

The following table summarizes the approaches for allocating proceeds attributable to a freestanding convertible debt instrument to components or features contained in the instrument:

<table>
<thead>
<tr>
<th>Allocation Approach</th>
<th>Allocation Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible instrument with a bifurcated embedded derivative (see Section 2.3)</td>
<td>With-and-without method. The embedded derivative is measured first at fair value, and the residual amount is allocated to the host contract. To measure the embedded derivative at fair value in a manner similar to a freestanding derivative instrument</td>
</tr>
<tr>
<td>Traditional convertible debt (see Chapter 4)</td>
<td>Not applicable. All of the proceeds are recorded as debt. To reflect the mutual exclusivity of debt repayment and conversion option exercise (i.e., both cannot happen)</td>
</tr>
<tr>
<td>Debt issued at a substantial premium (see Chapter 5)</td>
<td>With-and-without method. The debt is measured first at its principal amount, and the residual amount is allocated to equity. To record a substantial premium received in equity</td>
</tr>
<tr>
<td>Instrument with a CCF (see Chapter 6)</td>
<td>With-and-without method. The liability component is measured first at fair value, and the residual amount is allocated to the equity component. To reflect interest cost that is paid with the conversion feature</td>
</tr>
<tr>
<td>Instrument with a BCF (see Chapter 7)</td>
<td>With-and-without method. The BCF is measured first at its intrinsic value, and the residual amount is allocated to the instrument. To record the intrinsic value of the conversion feature in equity</td>
</tr>
</tbody>
</table>

An entity may also need to allocate any amount presented in equity between temporary and permanent equity on the basis of the instrument’s redemption amount (e.g., for debt with a CCF; see Section 2.6) to highlight that some or all of that amount may not be available to the issuer as a permanent source of equity financing.
Chapter 4 — Traditional Convertible Debt

4.1 Overview
Historically, the general approach to accounting for convertible debt has been not to recognize the equity conversion feature separately. Over time, however, numerous exceptions to this approach have been added to U.S. GAAP to better reflect the nature and characteristics of certain types of convertible debt (see Section 4.2 below).

Sections 4.3 and 4.4 describe the initial and subsequent accounting for traditional convertible debt that contains no separated equity conversion feature. Section 4.5 addresses derecognition issues associated with convertible debt instruments, including the accounting for conversions, extinguishments, modifications, and exchanges of such instruments. Finally, Section 4.6 discusses presentation and disclosure requirements applicable to convertible debt.

4.2 Scope

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
</table>
| 25-10 The guidance in paragraph 470-20-25-12 addresses debt instruments that have both of the following characteristics:  
  a. The debt instrument is convertible into common stock of the issuer or an affiliated entity at a specified price at the option of the holder.  
  b. The debt instrument is sold at a price or has a value at issuance not significantly in excess of the face amount. |
| 25-11 The terms of convertible debt instruments addressed by the guidance in the following paragraph generally include all of the following:  
  a. An interest rate that is lower than the issuer could establish for nonconvertible debt  
  b. An initial conversion price that is greater than the fair value of the common stock at time of issuance  
  c. A conversion price that does not decrease except pursuant to antidilution provisions. |
| In most circumstances, convertible debt instruments also are callable at the option of the issuer and are subordinated to nonconvertible debt. |
| 25-12 No portion of the proceeds from the issuance of the types of convertible debt instruments described in the preceding two paragraphs shall be accounted for as attributable to the conversion feature. |
| 25-16 The guidance in paragraphs 470-20-25-10 through 25-15 only addresses the accounting at issuance for convertible debt instruments and does not address accounting for changes to convertible debt instruments after issuance. |
The issuer of a convertible debt instrument to which ASC 470-20-25-12 applies (i.e., traditional convertible debt) is precluded from allocating any of the proceeds to equity. The application of this prohibition, which was in APB Opinion 14 before the FASB's codification of U.S. GAAP (the “Codification”), is limited to convertible debt instruments that have the characteristics described in ASC 470-20-05-4 and ASC 470-20-25-10 and 25-11. For example:

- The holder has an option to convert the debt into the common stock of the issuer (or one of its substantive subsidiaries; see Section 2.7) at a specified price.
- The holder cannot both exercise the conversion option and settle the debt in cash (i.e., the alternatives are mutually exclusive; see Section 3.4.2.2).
- The initial effective conversion price is greater than the fair value of the common stock at the time of issuance (i.e., the conversion feature was not in-the-money at inception).
- Except for standard antidilution provisions, the contractual terms do not specify any adjustments to the conversion price.
- The proceeds or value of the instrument at inception was “not significantly in excess of the face amount.”

GAAP contain several important exceptions to the prohibition in ASC 470-20-25-12 against giving separate accounting recognition to a conversion feature embedded in a convertible debt instrument:

- If the conversion feature meets the bifurcation criteria in ASC 815-15-25-1, it is accounted for separately from the debt host contract as a derivative at fair value, with changes in fair value recognized in earnings (see Section 2.3). In paragraph 293 of FASB Statement 133, the Board noted that it is “important that an entity not be able to avoid the recognition and measurement requirements of [ASC 815] merely by embedding a derivative instrument in a nonderivative financial instrument or other contract.”
- If the conversion feature was bifurcated as a derivative but no longer meets the bifurcation criteria in ASC 815-15, ASC 815-15-35-4 requires the issuer to reclassify the previously bifurcated conversion option into equity. As indicated in paragraph 5 of EITF Issue 06-7, when the EITF developed this requirement, it concluded that APB Opinion 14 “only addresses the accounting at issuance for convertible debt instruments and does not address accounting for changes to convertible debt instruments subsequent to issuance.”
- If the convertible debt can be settled in full or in part in cash upon conversion, the CCF guidance in ASC 470-20 (see Chapter 6) requires the issuer to separate an equity component unless the feature must be bifurcated as a derivative under ASC 815-15. Because the APB’s decision to preclude separation of the conversion option was based on the mutual exclusivity of the alternatives to convert the debt into equity shares or redeem the debt for cash (see Section 3.4.2.2), the FASB decided that ASC 470-20-25-12 should not apply if the convertible debt may be settled in whole or in part in cash upon conversion since the alternatives are not mutually exclusive.
- If the conversion feature is beneficial to the holder (i.e., it has intrinsic value on its commitment date), the BCF guidance in ASC 470-20 requires the separation of an equity component either at inception or upon the occurrence or nonoccurrence of a contingent event (see Chapter 7) unless either (1) the conversion feature must be bifurcated as a derivative under ASC 815-15 or (2) the convertible debt is subject to the CCF guidance in ASC 470-20. In paragraphs 1 and 2 of EITF Issue 98-5, which was the basis for the BCF guidance that was later codified in ASC 470-20, the EITF noted that APB Opinion 14 “does not explicitly address situations in which the embedded conversion feature is in-the-money at issuance [or] the conversion terms are contingently adjustable.”
If the convertible debt is modified or exchanged and the modification or exchange is not accounted for as an extinguishment, the amount of any increase in the fair value of the conversion feature associated with the modification or exchange reduces the carrying amount of the debt with a corresponding increase in equity (see Section 4.5.6). Regarding the development of this guidance, the EITF noted in its November 16, 2006, meeting minutes that APB Opinion 14 “only pertains to the accounting at issuance for convertible debt instruments and does not address the accounting for modifications to convertible debt instruments.”

If the convertible debt is issued at a substantial premium to its face amount, it is presumed that the premium should be accounted for in equity (see Chapter 5) unless the conversion feature requires bifurcation as a derivative under ASC 815-15-25-1 or an equity component has been separated under the CCF or BCF guidance in ASC 470-20. Paragraph 18 of APB Opinion 14 provided this exception, noting that “[s]ecurities not explicitly discussed in [the] Opinion should be dealt with in accordance with the substance of the transaction.”

4.3 Initial Accounting

Upon the initial recognition of traditional convertible debt, the issuer presents the entire amount attributable to the debt (see Section 3.5) as a liability; no amount is allocated to equity. If the issuer elects to account for the convertible debt at fair value on a recurring basis under the fair value option in ASC 825-10, any issuance costs are expensed at inception. If the fair value option is not elected, the issuer reduces the initial carrying amount of the debt by any direct and incremental issuance costs paid to third parties that are associated with the convertible debt issuance (see Section 3.5.3). The issuer should also determine whether the instrument contains any embedded features, other than the conversion feature, that must be bifurcated as derivatives under ASC 815-15-25-1 (e.g., a put option, a call option, or an interest rate adjustment feature).

In this chapter, it is assumed, unless otherwise stated, that the issuer is not required to separate any embedded derivative feature from the convertible debt instrument. Unless the issuer has elected to apply the fair value option, it should separately account for any bifurcated embedded derivative at fair value under ASC 815-15 (see Section 2.3 and Appendix A for further discussion of the evaluation of embedded derivatives).

Example 4-1

**Issuance of Traditional Convertible Debt Instrument Without Any Other Instruments**

Entity A issues a five-year convertible debt instrument at par for net cash proceeds of $8 million, which is its principal amount. The instrument has a stated interest rate of 1.5 percent per annum and an embedded conversion option that gives the holder the right to convert the debt on its maturity date into a fixed number of A’s shares of common stock subject to standard antidilution adjustments. The interest rate on the convertible debt is lower than that on similar nonconvertible debt issued by A, since investors are willing to accept a lower rate because of the value of the embedded conversion option. Entity A estimates that if the embedded conversion option had been issued separately as a freestanding financial instrument, its fair value at inception would have been $1 million, although the option is not in-the-money at issuance. Entity A has determined that the conversion option is not required to be bifurcated as a derivative under ASC 815-15 and that the convertible debt is within the scope of the accounting guidance in ASC 470-20-25-12. Therefore, A makes the following journal entry at issuance:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Convertible debt</td>
<td>8,000,000</td>
</tr>
</tbody>
</table>
4.4 **Subsequent Accounting**

Because ASC 470-20 does not address the subsequent measurement of traditional convertible debt, an issuer looks to other applicable GAAP for guidance. The subsequent accounting depends on whether the issuer has made an election to account for the debt at fair value on a recurring basis under the fair value option in ASC 825-10.

If the issuer has elected to apply the fair value option, it remeasures the convertible debt instrument at its fair value on each reporting date and reflects (1) the qualifying changes in fair value in earnings and (2) the portion of the changes that is attributable to a change in instrument-specific credit risk in other comprehensive income. If the issuer has not made such an election, the convertible debt is accounted for at amortized cost in accordance with the interest method described in ASC 835-30. (Reported interest expense on convertible debt to which ASC 470-20-25-12 applies is generally lower than on similar nonconvertible debt, since the issuer is “paying” for the low interest rate by providing an equity conversion feature that is not recognized for accounting purposes.)

In accordance with ASC 835-30-35-2, under the interest method, the amortization of a discount or premium is computed “in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period.” When nonputtable convertible debt is accounted for at amortized cost, any debt discounts and issuance costs are generally amortized over the contractual term to maturity. In practice, debt discounts and issuance costs on convertible debt that is puttable by the investor are amortized from the date of issuance to the earliest noncontingent put date rather than to the contractual maturity date. However, any debt premium is amortized over the debt's contractual life because recognizing the debt premium as a reduction of interest expense would be analogous to recognizing a gain contingency. Under ASC 470-10-35-1 and 35-2, if debt instruments have “a maturity date that can be extended at the option of the borrower [at an increasing interest rate] at each maturity date until final maturity,” debt discounts and issuance costs are amortized over the estimated outstanding term of the debt.

4.5 **Derecognition**

4.5.1 **Overview**

For traditional convertible debt, the issuer’s accounting for the conversion (or exchange) of the debt into equity shares in full satisfaction of the debt depends on the facts and circumstances, as follows:

- **Conversion in accordance with the instrument's original terms** — If the debt is converted into the issuer’s equity shares under the instrument’s original conversion terms (other than a share-settled redemption feature, which is discussed below) and the conversion was not triggered by the issuer’s exercise of a call option, the net carrying amount of the debt is credited to equity to reflect the shares issued, and no gain or loss is recognized (see Section 4.5.2).

- **Conversion upon the issuer’s exercise of a call option** — If the debt is converted into the issuer’s equity shares under the instrument’s original conversion terms (other than a share-settled redemption feature) and the debt had become convertible because the issuer had exercised a call option embedded in the debt, the accounting for the conversion depends on whether the conversion option was substantive when the debt was issued. If the conversion option was substantive at issuance, the conversion is accounted for as a conversion in accordance with the instrument’s original terms (see Section 4.5.3). If the conversion option was nonsubstantive at issuance, the conversion of the instrument into the issuer’s equity shares is accounted for as a debt extinguishment.
• **Induced conversions** — If the conversion of the debt into the issuer’s equity shares qualifies as an “induced conversion” as described in ASC 470-20, the issuer (1) recognizes “an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable [under] the original conversion terms” and (2) credits the excess amount and the net carrying amount of the debt to equity to reflect the shares issued (see Section 4.5.4).

• **Conversion in a TDR** — If the debt is converted into the issuer’s equity shares under a TDR as defined in ASC 470-60 and the transaction is not a related-party transaction, the issuer (1) recognizes the difference between the fair value of the equity interest granted and the net carrying amount of the debt as a restructuring gain and (2) credits the fair value of the shares issued to equity (see Section 4.5.7). If the holder is a related party, the issuer should consider whether the transaction represents a capital transaction (see Section 4.5.5.3).

• **Other conversions and exchanges** — If the debt is converted (or exchanged) into the issuer’s equity shares in accordance with a share-settled redemption feature or on different terms from those at issuance, and the transaction is not accounted for as an induced conversion or TDR and is not a related-party transaction, the conversion is accounted for as a debt extinguishment. In such a case, the issuer (1) recognizes an extinguishment gain or loss equal to the difference between the reacquisition price and the net carrying amount of the extinguished debt and (2) credits the reacquisition price to equity to reflect the shares issued (see Section 4.5.5). If the holder is a related party, the issuer should consider whether the transaction represents a capital transaction (see Section 4.5.5.3).

Like other debt, traditional convertible debt is derecognized when it is extinguished (e.g., through a repurchase or repayment of the debt in full satisfaction of the debt obligation). Upon a debt extinguishment, the issuer recognizes an extinguishment gain or loss equal to the difference between the reacquisition price and the net carrying amount of the extinguished debt (see Section 4.5.5). If the holder is a related party, the issuer should consider whether a debt extinguishment represents a capital transaction (see Section 4.5.5.3). Modifications and exchanges of debt instruments (see Section 4.5.6) and TDRs (see Section 4.5.7) are subject to specialized guidance.

### 4.5.2 Conversion in Accordance With the Instrument’s Original Terms

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-4</strong> If a convertible debt instrument does not include a beneficial conversion feature, the carrying amount of the debt, including any unamortized premium or discount, shall be credited to the capital accounts upon conversion to reflect the stock issued and no gain or loss is recognized.</td>
</tr>
</tbody>
</table>

ASC 470-20-40-4 specifies the general approach to accounting for a conversion of traditional convertible debt into the issuer’s equity shares when the conversion occurs in accordance with the original terms of the debt. Under this approach, the carrying amount of the debt is credited to equity, and no gain or loss is recognized. For example, depending on the circumstances, the issuer may make the following accounting entry:

```
Convertible debt

Equity — common stock
```
The carrying amount of the debt reflects any remaining unamortized discount or premium as of the date of conversion as well as any remaining unamortized debt issuance costs as of that date, in accordance with the definition of “net carrying amount of debt” in ASC 470-50. To recognize the appropriate carrying amount within equity, the issuer should amortize any premium or discount and debt issuance costs up to the date the instrument is converted. As indicated in ASC 470-20-40-11, the carrying amount also includes any “accrued interest from the last interest payment date, if applicable, to the date of conversion, net of related income tax effects, if any,” irrespective of whether accrued unpaid interest is forfeited upon conversion (see Section 4.5.2.1 below).

This accounting does not apply to any of the following transactions involving traditional convertible debt:

- A conversion that occurs upon the issuer’s exercise of a call option if the instrument did not contain a substantive conversion feature as of its issuance date (see Section 4.5.3).
- Induced conversions as described in ASC 470-20-40-13 (see Section 4.5.4).
- A conversion in accordance with a TDR as defined in ASC 470-60 (see Section 4.5.7).
- A conversion of a traditional convertible debt instrument with a separately recognized equity component that is not a BCF (see Section 4.5.2.2).

Further, this accounting does not apply to:

- A conversion of a convertible debt instrument that contained a recognized BCF (see Section 7.6.1).
- A conversion of a convertible debt instrument that contained a CCF (see Section 6.5).
- A conversion that occurs in accordance with the terms of a share-settled redemption feature (see Sections 2.4 and 4.5.5.1).
- An exchange of debt into the shares of a third party (see Section 2.7).

See Appendix B for a discussion of the accounting for a conversion of a convertible debt instrument for which the embedded conversion option has been separated as an embedded derivative liability.

### 4.5.2.1 Interest Forfeiture

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-9</strong> When a convertible debt instrument is converted to equity securities, sometimes the terms of conversion provide that any accrued but unpaid interest at the date of conversion is forfeited by the former debt holder. This occurs either because the conversion date falls between interest payment dates or because there are no interest payment dates (a zero coupon convertible instrument).</td>
</tr>
<tr>
<td><strong>35-11</strong> If the terms of conversion of a convertible debt instrument provide that any accrued but unpaid interest at the date of conversion is forfeited by the former debt holder, that interest should be accrued or imputed to the date of conversion of the debt instrument.</td>
</tr>
<tr>
<td><strong>40-11</strong> If the terms of conversion of a convertible debt instrument provide that any accrued but unpaid interest at the date of conversion is forfeited by the former debt holder, accrued interest from the last interest payment date, if applicable, to the date of conversion, net of related income tax effects, if any, shall be charged to interest expense and credited to capital as part of the cost of securities issued. Thus, the accrued interest is accounted for in the same way as the principal amount of the debt converted and any unamortized issue premium or discount; the net carrying amount of the debt, including any unamortized premium or discount and the related accrual for interest to the date of conversion, net of any related income tax effects, is a credit to the entity’s capital.</td>
</tr>
</tbody>
</table>
Although the terms of a convertible debt instrument may specify that the holder forfeits any right to accrued unpaid interest upon a conversion (e.g., if the conversion date falls between interest payment dates or the convertible debt is a zero-coupon instrument), the issuer is nevertheless required to accrue interest cost to the date of conversion. The forfeiture of accrued interest is not treated as a forgiveness of the associated liability. The amount of interest is computed by using the interest method in ASC 835-30. The accrued interest cost, net of any related income tax effects, is credited to equity as part of the cost of the equity shares issued.

4.5.2.2 Conversion of Debt With a Separately Recognized Equity Component for Reasons Other Than a BCF or CCF

No separate equity component is recognized upon the initial issuance of a traditional convertible debt instrument. However, after the issuance of such an instrument, an equity component may be recognized if the issuer (1) reclassifies an embedded conversion feature that was previously classified as an embedded derivative liability to equity (see ASC 815-15-35-4) or (2) modifies or exchanges the convertible debt instrument in a transaction that does not result in extinguishment but includes an increase in the fair value of the embedded conversion option (see Section 4.5.6).

ASC 815-15-40-1 addresses the accounting in a scenario in which a convertible debt instrument with a separate equity component that resulted from a previous reclassification of the embedded conversion option from a liability to equity is converted in accordance with the instrument's original terms. ASC 815-15-40-1 states:

If a holder exercises a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to paragraph 815-15-35-4, the issuer shall recognize any unamortized discount remaining at the date of conversion immediately as interest expense.

A traditional convertible debt instrument may contain an equity component that resulted from a previous modification or exchange that increased the conversion option's fair value (see Section 4.5.6). The Codification does not specifically address the accounting for any unamortized discount that remains on the conversion date if such an instrument is converted into common stock in accordance with the instrument's original conversion terms. However, given the similarities between the accounting for (1) a conversion of a convertible debt instrument with a BCF (see Section 7.6.1) and (2) a separately recognized equity component that resulted from a previous reclassification of the embedded conversion option from a liability to equity, we believe that an entity should immediately amortize any unamortized discount on the debt that remains on the instrument's conversion date in accordance with its original conversion terms and recognize such amount as an expense.

4.5.2.3 Debt Tendered Upon Exercise of Detachable Warrants

The guidance in this Subtopic does not apply to debt tendered to exercise detachable warrants that were originally issued with that debt if the debt is permitted to be tendered towards the exercise price of the warrants under the terms of the securities at issuance. The tendering of the debt in such a case would be accounted for in the same manner as a conversion.

If debt is tendered for the exercise of detachable warrants, the transaction is accounted for as a conversion rather than as a debt extinguishment if both of the following conditions are met: (1) the warrants were originally issued with that debt and (2) the original terms permit the debt to be tendered toward the exercise price of the warrants (see also Section 3.4.2.3).
### 4.5.3 Conversion Upon Issuer's Exercise of a Call Option

#### 4.5.3.1 General Considerations

<table>
<thead>
<tr>
<th>Convertibility of Debt Instrument</th>
<th>Conversion Feature Substantive at Inception</th>
<th>Conversion Feature Not Substantive at Inception</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible only upon the issuer's exercise of a call option</td>
<td>N/A (By definition, such a conversion option is not substantive as of the issuance date.)</td>
<td>Accounted for as an extinguishment.</td>
</tr>
<tr>
<td>Convertible upon the issuer's exercise of a call option and could otherwise become convertible in the future</td>
<td>Accounted for as a conversion.</td>
<td>Accounted for as an extinguishment.</td>
</tr>
<tr>
<td>Currently convertible even if the issuer has not exercised its call option</td>
<td>Accounted for as a conversion. Because the instrument is convertible without the issuer's exercise of a call option, the accounting does not depend on whether the conversion option was substantive on the issuance date.</td>
<td></td>
</tr>
</tbody>
</table>

Sometimes, the terms of a convertible debt instrument include both (1) an option for the issuer to call the instrument and (2) a right for the holder to exercise the conversion feature if the issuer calls the instrument. In this circumstance, the accounting for the conversion of the instrument into the issuer's equity shares in accordance with the original terms of the debt depends on whether the conversion feature was (1) otherwise currently convertible and (2) substantive as of the instrument's issuance date.

If the conversion option is nonsubstantive at issuance and the instrument becomes convertible upon the issuer's exercise of the call option, the conversion of the instrument into equity shares is accounted for as a debt extinguishment (see Section 4.5.5) and the holder's election to convert the debt is analyzed as a debt settlement alternative instead of a conversion privilege. As long as the conversion feature is nonsubstantive at issuance, and provided that the holder does not currently have the ability to convert the instrument unless the issuer exercises its call option, extinguishment accounting applies even if the instrument would have become convertible upon the passage of time (e.g., a conversion option that becomes exercisable on the instrument's maturity date or on specified prior dates).
The conversion of an instrument into the issuer’s equity shares is accounted for as a conversion as long as it otherwise qualifies for such accounting if either (1) the conversion feature is substantive at issuance or (2) the holder has the ability to exercise the conversion feature irrespective of the issuer’s exercise of its call option.

This guidance does not apply to any of the following transactions involving traditional convertible debt:

- A conversion in accordance with a TDR as defined in ASC 470-60 (see Section 4.5.7).
- Induced conversions as described in ASC 470-20 (see Section 4.5.4).

Further, this accounting does not apply to:

- A conversion that occurs in accordance with the terms of a share-settled redemption feature (see Sections 2.4 and 4.5.5.1).
- An exchange of debt into the shares of a third party (see Section 2.7).
- A conversion of an instrument that was separated into liability and equity components in accordance with the CCF guidance in ASC 470-20 (see Section 6.5).

### 4.5.3.2 Determining Whether a Conversion Feature Is Substantive

<table>
<thead>
<tr>
<th>ASC 470-20 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Substantive Conversion Feature</strong></td>
</tr>
<tr>
<td>A conversion feature that is at least reasonably possible of being exercisable in the future absent the issuer’s exercise of a call option.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-6</strong> The assessment of whether the conversion feature is substantive may be performed after the issuance date but shall be based only on assumptions, considerations, and marketplace information available as of the issuance date.</td>
</tr>
<tr>
<td><strong>40-7</strong> By definition, a substantive conversion feature is at least reasonably possible of being exercised in the future. If the conversion price of an instrument at issuance is extremely high so that conversion of the instrument is not deemed at least reasonably possible as of its issuance date, then the conversion feature would not be considered substantive.</td>
</tr>
<tr>
<td><strong>40-8</strong> For purposes of determining whether a conversion feature is reasonably possible of being exercised, the assessment of the holder’s intent is not necessary. Therefore, even if such an instrument included a conversion feature that provided for conversion due solely to the passage of time (for example, the instrument will become convertible at a date before its maturity date), it would be inappropriate to conclude that the conversion feature is substantive. Also, an instrument that became convertible only upon the issuer’s exercise of its call option does not possess a substantive conversion feature.</td>
</tr>
</tbody>
</table>
Methods that may be helpful in assessing whether a conversion feature is substantive include the following:

a. The fair value of the conversion feature relative to the fair value of the debt instrument. Comparing the fair value of a conversion feature to the fair value of the debt instrument (that is, the complete instrument as issued) may provide evidence that the conversion feature is substantive.

b. The effective annual interest rate per the terms of the debt instrument relative to the estimated effective annual rate of a nonconvertible debt instrument with an equivalent expected term and credit risk. Comparing the effective annual interest rate of the debt instrument to the effective annual rate the issuer estimates it could obtain on a similar nonconvertible instrument may provide evidence that a conversion feature is substantive.

c. The fair value of the debt instrument relative to an instrument that is identical except for which the conversion option is not contingent. Comparing the fair value of the debt instrument to the fair value of an identical instrument for which conversion is not contingent isolates the effect of the contingencies and may provide evidence about the substance of a conversion feature. If the fair value of the debt instrument is similar to the fair value of an identical convertible debt instrument for which conversion is not contingent, then it may indicate that the conversion feature is substantive. However, this approach may not be appropriate unless it is clear that the conversion feature, not considering the contingencies, is substantive.

d. Qualitative evaluation of the conversion provisions. The nature of the conditions under which the instrument may become convertible may provide evidence that the conversion feature is substantive. For example, if an instrument may become convertible upon the occurrence of a specified contingent event, the likelihood that the contingent event will occur before the instrument's maturity date may indicate that the conversion feature is substantive. However, this approach may not be appropriate unless it is clear that the conversion feature, not considering the contingencies, is substantive.

The guidance in paragraphs 470-20-40-7 through 40-9 does not address the treatment of an instrument for purposes of applying Subtopic 260-10.

An issuer’s evaluation of whether a conversion option is substantive as of the debt’s issuance date reflects the assumptions, considerations, and marketplace information available as of the issuance date even if the evaluation is performed on a subsequent date.

A conversion option may be deemed substantive if — as of the instrument’s issuance date — there is at least a reasonable possibility that it will become exercisable by the holder upon (1) the passage of time or (2) the occurrence or nonoccurrence of a specified event (other than the issuer’s exercise of the call option) that is likely to occur. However, in accordance with ASC 470-20-40-7, a conversion option that has a reasonable possibility of becoming exercisable would not be considered substantive if, as of the instrument’s issuance date, its exercise is not reasonably possible (e.g., because the conversion option is deeply out-of-the-money).

Under ASC 470-20, a conversion feature would not be considered substantive as of the instrument’s issuance date in any of the following circumstances:

- The holder has no ability to exercise the conversion feature (i.e., it is not exercisable) unless the issuer exercises its call option.
- It is not reasonably possible for the holder to obtain the ability to exercise the conversion feature (i.e., it is not reasonably possible that the feature will become exercisable) unless the issuer exercises its call option. For example, this would be the case if the only circumstance in which the holder can obtain a right to convert the instrument (other than the issuer’s exercise of the call option) is a specified event that does not have a reasonable possibility of occurring.
It is not reasonably possible that the holder will exercise the conversion feature (e.g., the conversion price is extremely high relative to the current share price as of the issuance date).

In evaluating whether a conversion option is substantive as of the issuance date in accordance with ASC 470-20-40-9 (e.g., when determining whether it is reasonably possible that the holder will exercise the conversion feature), entities should consider the following:

- The smaller the fair value of the conversion feature relative to the fair value of the debt instrument, the more likely it is that the conversion option is not substantive.
- The smaller the difference between the convertible debt's effective interest rate and the effective interest rate on a hypothetical nonconvertible debt instrument with the same terms except for the conversion feature, the more likely it is that the conversion option is not substantive.
- The smaller the difference between the fair value of the convertible debt and the fair value of a hypothetical convertible debt instrument with the same terms (except that the conversion feature is not contingent), the more likely it is that the conversion option is not substantive.
- The smaller the likelihood of a contingent event that would make the conversion feature exercisable, the more likely it is that the conversion option is not substantive.

**Connecting the Dots**

Section 3.2 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity* discusses the determination of whether a feature is substantive under ASC 480-10.

### 4.5.3.3 Illustrations

**ASC 470-20**

**Example 9: Illustration of a Conversion of an Instrument That Becomes Convertible Upon the Issuer’s Exercise of a Call Option**

This Example illustrates an instrument subject to the guidance in paragraphs 470-20-40-5 through 40-9.

An entity issues a contingently convertible instrument on January 1, 2006, with a market price trigger, a $1,000 par amount, and a maturity date of December 31, 2020. The debt instrument is convertible at the option of the holder if the share price of the issuer exceeds a specified amount. The issuer can call the debt at any time between 2009 and the maturity date of the debt. If the issuer calls the debt, the holder has the option to receive cash for the call amount or a fixed number of shares as specified in the terms of the instrument upon issuance, regardless of whether the market price trigger has been met. In 2010, the issuer calls the debt before the market price trigger being met and the holder elects to receive a fixed number of shares (as specified in the terms of the instrument).

Example 9 in ASC 470-20-55 describes a contingently convertible instrument (CoCo) and includes the following key assumptions:

- The CoCo, which has a par amount of $1,000, was issued on January 1, 2006, and matures on December 31, 2020.
- The issuer has the right to call the CoCo at any time between 2009 and its maturity date. If the CoCo is called, the issuer will settle the call amount of the CoCo (e.g., $1,000) in cash unless the holder elects to convert the debt into a fixed number of the issuer’s shares.
• The holder has a contingent right to convert the CoCo into a fixed number of shares (e.g., 10 shares) that is exercisable only if either (1) a specified market price trigger is met (i.e., the issuer’s share price exceeds a specified amount) or (2) the issuer exercises its right to call the CoCo (in this case, the holder obtains the right to convert the CoCo irrespective of whether the market price trigger is met).

• In 2010, the issuer calls the CoCo. At this time, the market price trigger has not been met. The holder elects to convert the CoCo into a fixed number of shares instead of receiving the call amount in cash.

In Example 9 in ASC 470-20-55, the holder did not have the ability to convert the CoCo debt before the issuer called it because the market price trigger had not been met. Therefore, the conversion would be evaluated on the basis of the accounting guidance on conversions upon an issuer’s exercise of a call option in ASC 470-20-40-5. If the conversion feature was substantive at issuance, the conversion would be accounted for as a conversion (see Section 4.5.2). If the feature was nonsubstantive at issuance, the conversion would be accounted for as an extinguishment (see Section 4.5.5).

If the facts were altered so that the market-price trigger had been met when the issuer exercised its call option, the accounting guidance on conversions upon the issuer’s exercise of a call option in ASC 470-20-40-5 would not apply because the holder already had an unconditional right to elect to convert the debt when the issuer elected to call it. In this case, the conversion would be accounted for as a conversion irrespective of whether the conversion feature was substantive at issuance.

When the EITF developed the guidance on accounting for the conversion of an instrument that became convertible upon the issuer’s exercise of a call option, the FASB staff prepared illustrations of the application of the guidance. Example 1 in EITF Issue 05-1, Issue Summary 1, Supplement 3 (March 3, 2006), states:

An entity issues a CoCo for par in the amount of $1,000 and a maturity date of December 31, 2025. The issuer can call the bond for its par amount at any time after December 31, 2008, and the holder may put back the bond to the issuer for its par value on the following dates: January 1, 2010, and January 1, 2020. The coupon rate of the bond is 3.5 percent. If the issuer calls the CoCo, the holder has 30 days to receive cash for the accreted value of the instrument or 10 shares of common stock. At the bond’s issuance date, the issuer’s stock price is $70 and the holder can convert the bond into 10 shares of common stock upon the occurrence of either of the following events:

a. The market price of the issuer’s stock exceeds $120 for a consecutive 30-day period

b. Consummation of a change in control of the issuer.
The FASB staff analyzed three different scenarios related to Example 1 and indicated whether they should be evaluated under the guidance that was subsequently incorporated into ASC 470-20-40-5:

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>Subject to an Evaluation Under ASC 470-20-40-5</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;The issuer's stock price exceeds $120 for 30 consecutive trading days from May 1 to May 30, 2009, and, on May 30, 2009, when its share price is $121, the issuer calls the CoCo. On June 29, 2009, the issuer's share price is $110 and the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100.&quot;</td>
<td>No. &quot;Because the CoCo was convertible at the discretion of the holder immediately prior to the issuer's exercise of its call option, the conversion is not within the scope of [ASC 470-20-40-5].&quot;</td>
<td>&quot;The carrying amount of the debt is credited to equity, and no gain or loss is recognized.&quot;</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 2</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;The issuer's stock price exceeds $120 for 29 consecutive trading days from May 1 to May 29, 2009, and on May 29, 2009, the issuer calls the CoCo. The stock price on the call date is $150 per share. The value of the CoCo immediately prior to the call is $1,500. On June 28, 2009, the stock price is $140 and the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,400.&quot;</td>
<td>Yes. &quot;This scenario is within the scope of [ASC 470-20-40-5]. The holder did not have the legal right to convert based on the CoCo's market price trigger prior to the issuer's exercise of its call option on May 29, 2009.&quot;</td>
<td>Because the conversion feature was substantive at issuance, &quot;the subsequent conversion of the instrument is deemed to have occurred pursuant to the instrument's original terms and no gain or loss is recognized. The carrying value of the CoCo is credited to equity.&quot;</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 3</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;As of January 1, 2024, the instrument is not convertible at the discretion of the investor, the stock price is $110 and the issuer exercises its call option. The holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100. The fair value of the CoCo immediately prior to the call is $1,045.&quot;</td>
<td>Yes. &quot;When the issuer exercised its call option on January 1, 2025, the holder did not have the legal right to convert based on the CoCo's stated contingent triggers. This scenario is within the scope of [ASC 470-20-40-5] because the issuer provides the holder with the opportunity to convert, which it did not have otherwise.&quot;</td>
<td>Because the conversion feature was substantive at issuance, &quot;the subsequent conversion of the instrument after conversion is deemed to have occurred pursuant to the instrument's original terms and no gain or loss is recognized.&quot;</td>
</tr>
</tbody>
</table>

Further, EITF Issue 05-1, Issue Summary 1, Supplement 1 (May 27, 2005), contains the examples below.
### Example 1, Convertible Debt Security

"An entity issues a convertible bond for par in the amount of $1,000 and a maturity date of December 31, 2025. The issuer can call the bond for its par amount at any time after December 31, 2008, and the holder may put back the bond to the issuer for its par value on the following dates: January 1, 2010, and January 1, 2020. At the bond's issuance date, the issuer's stock price is $70 and the holder can convert the bond into 10 shares at any time. If the issuer calls the debt, the holder has the option of receiving cash for the par amount or 10 shares. On January 1, 2009, the issuer calls the bond when its stock price is $110. The holder has the option of receiving cash for the par amount ($1,000) or 10 shares of stock with a market value of $1,110. The holder elects to convert the bond and receive 10 shares of stock."

No. "The issuer’s exercise of the call option resulted in the holder converting the bond into shares on January 1, 2009. However, because in this fact pattern the holder has the ability to convert the bond into 10 shares at anytime, the conversion does not fall within the scope of ASC 470-20-40-5."

### Example 2, Contingently Convertible Debt

"An entity issues a CoCo for par in the amount of $1,000 and a maturity date of December 31, 2025. The issuer can call the bond for its par amount at any time after December 31, 2008, and the holder may put back the bond to the issuer for its par value on the following dates: January 1, 2010, and January 1, 2020. At the bond's issuance date, the issuer's stock price is $70 and the holder can convert the bond into 10 shares of common stock upon the occurrence of any one of the following three events:

1. If the issuer calls the CoCo, the holder has the option to receive cash for the par amount of the instrument or exercise its conversion option and receive 10 shares of common stock.
2. If the market price of the issuer's stock exceeds $120 for a consecutive 30-day period (market price trigger), the CoCo becomes convertible at the holder’s option during the subsequent calendar quarter.
3. Upon the consummation of a change in control of the issuer, the holder of the CoCo can exercise its conversion option."

See individual scenarios below.

### Example 2, Scenario 1

"The issuer’s stock price exceeds $120 for 30 consecutive trading days from May 1 to May 30, 2009, which pursuant to the original terms of the CoCo provides the holder with the option to convert anytime from July 1 through September 30, 2009. On September 30, 2009, the issuer's share price is $110 and the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100."

No. Because the CoCo could be converted at the holder's discretion immediately before the issuer exercised its call option, the conversion is not within the scope of ASC 470-20-40-5.

### Example 2, Scenario 2

"The issuer’s stock price exceeds $120 for 29 consecutive trading days from May 1 to May 29, 2009, and on May 29, 2009, the issuer calls the CoCo when the stock price is $150 per share. The holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,500."

Yes. "When the issuer exercised its call option on May 29, 2009, the holder did not have the legal right to convert based on the CoCo’s market price trigger contingency provision because the market price trigger was only satisfied for 29 days and, therefore, falls one day short of the 30 day requirement stipulated in the original terms of the CoCo. This scenario is within the scope of [ASC 470-20-40-5] because the issuer provides the holder with the opportunity to convert, which it would not have had otherwise."
Table (continued)

<table>
<thead>
<tr>
<th>Example</th>
<th>Subject to an Evaluation Under ASC 470-20-40-5</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 2, Scenario 3</strong>&lt;br&gt;“On January 1, 2009, the issuer announces that it is selling 100 percent of its outstanding shares for $110 per share and that the transaction will be consummated on February 1, 2009. In contemplation of the transaction, the issuer’s stock price increases to $110. On February 1, 2009, the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100 and those shares are tendered to the acquiring company in exchange for $1,100.”&lt;br&gt;&lt;br&gt;No. The holder obtained a right to convert the CoCo through a change-of-control contingency, so this scenario is not within the scope of ASC 470-20-40-5.</td>
<td></td>
</tr>
<tr>
<td><strong>Example 2, Scenario 4</strong>&lt;br&gt;“On January 1, 2009, the issuer announces that it is selling 100 percent of its outstanding shares for $110 per share and the transaction will be consummated on February 1, 2009. The issuer’s stock price increases to $110 in contemplation of the transaction. On January 29, 2009, the issuer calls the CoCo when its stock price is $110. On January 29, 2009, the holder elects to convert the CoCo and receives 10 shares of common stock valued at $1,100.”&lt;br&gt;&lt;br&gt;Yes. “When the issuer exercised its call option on January 29, 2009, the holder did not have the ability to convert based on the change of control contingency. This scenario is within the scope of [ASC 470-20-40-5] because the issuer provides the holder with the opportunity to convert, which it would not have had otherwise.”</td>
<td></td>
</tr>
</tbody>
</table>

### 4.5.4 Induced Conversions

#### 4.5.4.1 Scope

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-10</strong> Some convertible debt instruments include provisions allowing the debtor to alter terms of the debt to the benefit of debt holders. In some circumstances, conversion privileges for a convertible debt instrument are changed or additional consideration is paid to debt holders for the purpose of inducing prompt conversion of the debt to equity securities (sometimes referred to as a convertible debt sweetener). Such provisions may be general in nature, permitting the debtor or trustee to take actions to protect the interests of the debt holders, or they may be specific, for example, specifically authorizing the debtor to temporarily reduce the conversion price for the purpose of inducing conversion.</td>
</tr>
<tr>
<td><strong>40-13</strong> The guidance in paragraph 470-20-40-16 applies to conversions of convertible debt to equity securities pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. That guidance applies only to conversions that both:&lt;br&gt;&lt;br&gt;a. Occur pursuant to changed conversion privileges that are exercisable only for a limited period of time (inducements offered without a restrictive time limit on their exercisability are not, by their structure, changes made to induce prompt conversion)&lt;br&gt;&lt;br&gt;b. Include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted, regardless of the party that initiates the offer or whether the offer relates to all debt holders.</td>
</tr>
<tr>
<td><strong>40-14</strong> A conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt. The preceding paragraph also includes conversions pursuant to amended or altered conversion privileges on such instruments, even though they are literally provided in the terms of the debt at issuance.</td>
</tr>
</tbody>
</table>
The changed terms may involve any of the following:

- A reduction of the original conversion price thereby resulting in the issuance of additional shares of stock
- An issuance of warrants or other securities not provided for in the original conversion terms
- A payment of cash or other consideration to those debt holders that convert during the specified time period.

The guidance in the following paragraph does not apply to conversions pursuant to other changes in conversion privileges or to changes in terms of convertible debt instruments that are different from those described in this paragraph.

Sometimes, convertible debt is converted into the issuer’s equity shares in accordance with changed conversion terms that are effective for a limited period, involve additional consideration, and are designed to induce conversion (also known as an “inducement offer”). Paragraph 16 of FASB Statement 84 (this paragraph was not codified) provides the following background information about such transactions:

A debtor sometimes wishes to induce prompt conversion of its convertible debt to equity securities to reduce interest costs, to improve its debt-equity ratio, or for other reasons. Thus, the debtor may offer additional consideration as an inducement for debt holders to convert promptly. This additional consideration can take many forms, including a temporary improvement of the conversion ratio (effected by a reduction of the conversion price), the issuance of warrants or other securities, or the payment of a cash incentive or other assets to debt holders who convert by a specified date.

If traditional convertible debt is converted in accordance with an inducement offer that meets certain conditions, neither conversion accounting (as described in Section 4.5.2) nor extinguishment accounting (as described in Section 4.5.5) applies. Instead, the issuer must recognize an inducement expense upon conversion. Such accounting applies to conversions that have all of the following characteristics:

- The original terms of the debt contained conversion privileges (i.e., the debt was convertible into the issuer’s equity shares).
- Either the debtor or the holder offered revised conversion terms that gave the holder an economic incentive to convert. For example, a debtor might offer each holder that elects to accept the inducement offer a reduced conversion price, additional instruments (e.g., warrants), or cash or other consideration in addition to the shares that would have been issued under the original conversion terms (“sweeteners”).
- The inducement offer had a restrictive time limit on its exercisability that is intended to induce a prompt conversion. In paragraph 34 of the Basis for Conclusions of Statement 84, the FASB justifies this requirement by noting that “inducements offered without a restrictive time limit on their exercisability are not, by their structure, changes made to induce prompt conversion.” Although ASC 470-20-40-13(a) does not address the extent of the time limit, the examples in ASC 470-20-55 imply that 30 or 60 days could qualify as “a limited period of time.” In paragraph 34, the FASB justifies the absence of a maximum time period by indicating that “any period so specified would be arbitrary and . . . the terms of conversion inducement offers may vary according to the circumstances.” When the conversion terms are altered for the remaining term of the convertible debt instrument, a modification of the convertible debt instrument has occurred (see Section 4.5.6).
- The convertible debt was converted under the revised conversion terms.
• For each converted instrument, all equity securities that were issuable in accordance with the original terms of the convertible debt were issued (i.e., the conversion might result in the issuance of additional but not fewer shares than contemplated in the original conversion terms of each converted instrument). In paragraph 33 of the Basis for Conclusions of Statement 84, the FASB explains this requirement, stating that “a transaction that does not include the issuance of all of the equity securities issuable pursuant to the conversion privileges should not be characterized as a conversion transaction.”

Therefore, induced conversion accounting does not apply in any of the following circumstances:

• The original debt instrument did not contain a conversion feature.
• The instrument was converted under the original conversion terms.
• The terms were adjusted for some purpose other than to induce conversion (e.g., to settle a legal dispute about the correct interpretation of the conversion terms).
• The offer was not for a limited period.
• The changed conversion privileges have no stated expiration date or are available for the remaining term of the convertible debt.
• The inducement offer involves the issuance of fewer equity securities than were issuable under the original conversion terms.
• The inducement offer involves the issuance of different equity securities than those that were issuable under the original conversion terms (e.g., preferred stock instead of common stock).
• The fair value of the consideration transferred is equal to or less than the fair value of the securities issuable under the original conversion terms.

In the evaluation of whether inducement accounting applies, it does not matter whether:

• The inducement offer is initiated by the debtor or the holder.
• The inducement offer is provided to all holders, some holders, or only one holder of the debt.
• The inducement transaction involves the legal exercise of contractual conversion privileges (i.e., the legal form of the inducement transaction does not matter; a repurchase of convertible bonds in exchange for the issuer’s equity shares might need to be accounted for as an induced conversion).
• The ability to modify the conversion terms to induce conversion was contemplated in the original terms of the debt instrument.
• The inducement offer involves the issuance of equity securities only or a combination of equity securities and cash or other consideration (as long as the inducement offer does not reduce the number of equity shares issuable).
• The original conversion terms did not permit conversion during the period of the inducement offer.

Paragraph 29 of the Basis for Conclusions of FASB Statement 84 explains why inducement accounting might apply even if the original terms of the debt instrument permit contractual revisions to induce conversion (e.g., a subjective modification provision; see Section 4.3.9.1 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity):

The Board is aware that some convertible debt instruments include provisions allowing the debtor to alter terms of the debt to the benefit of debt holders in a manner similar to transactions described in [ASC 470-20-40-13 through 40-15]. Such provisions may be general in nature, permitting the debtor or trustee to take
actions to protect the interests of the debt holders, or they may be specific, for example, specifically authorizing the debtor to temporarily reduce the conversion price for the purpose of inducing conversion. The Board concluded that conversions pursuant to amended or altered conversion privileges on such instruments, even though they are literally “provided in the terms of the debt at issuance,” should be included within the scope of [induced conversion accounting]. The Board concluded that the substantive nature of the transaction should govern. The Board believes that the existence of provisions in terms of the debt permitting changes to the conversion privileges should not influence the accounting.

Example 4-2

**Evaluation of Conversion as an Induced Conversion**

As noted above, the determination of whether inducement accounting applies does not depend on (1) the party that initiates the offer (i.e., the debtor or the debt holder) or (2) whether the offer is related to all debt holders or extends to one or more specific debt holders. EITF Issue 02-15 contains the following example (not codified) that illustrates these points:

Company A issued publicly traded convertible bonds (the Bonds) during a prior period. Currently, the Bonds are trading at a price that is significantly less than the carrying value (possibly due to a decline in Company A’s stock price or credit rating or both). The original conversion price of the Bonds is $50 (20 shares of common stock per bond), and Company A’s common stock is currently trading at $25 per share. On an individual basis, bondholders approach Company A with an offer for Company A to purchase the Bonds by providing consideration in excess of the conversion terms. Assume that on the date of the exchange, each Bond has the following values:

- Company A’s carrying value of the Bonds: $1,000
- Current fair market value of the Bonds: $750

A bondholder approaches Company A with the following two independent offers that are exercisable by Company A for a limited period of time:

1. Company A may purchase the Bonds in exchange for the Bonds’ original conversion of 20 shares of Company A common stock ($500 fair market value) and $300 cash.
2. Company A may purchase the Bonds in exchange for 32 shares of Company A common stock ($800 fair market value).

In this example, if the debtor accepts one of the offers, induced conversion accounting is required even though (1) the offers are made by individual debt holders rather than the debtor, (2) the offers do not involve all debt holders, and (3) the net carrying amount of the debt exceeds the fair value of the consideration issuable under the offers. Thus, as indicated in paragraph 5 of EITF Issue 02-15, induced conversion accounting might apply to a conversion for consideration in excess of the original conversion terms after “a third party purchases debt securities in the open market (at a significant discount from face value) and approaches the debtor to increase the conversion terms.”

The guidance in ASC 470-20-40-14 implies that the induced conversion guidance for traditional convertible debt applies to an exchange of a convertible debt instrument for shares (or cash and shares) that meets the conditions in ASC 470-20-40-13, even if the exchange does not involve the legal exercise of the contractual conversion privileges included in the terms of the debt. Therefore, induced conversion accounting applies if an issuer, in accordance with an offer that is available for a limited period, repurchases convertible debt in exchange for consideration that includes (1) all of the equity shares that would have been issuable under the original conversion terms and (2) additional consideration (e.g., cash, additional shares, or both, with a fair value equal to the time value of the conversion feature). For example, induced conversion accounting applies if an entity repurchases convertible debt that is convertible into 100 million shares in exchange for 100 million shares plus $5 million of cash.

However, induced conversion accounting does not apply if the repurchase involves fewer equity shares than were issuable under the original conversion terms, even if the total consideration is in excess of the fair value of the equity shares that would have been issuable under the original terms. For example, induced conversion accounting does not apply if an entity repurchases convertible debt that
is convertible into 100 million shares in exchange for 95 million shares plus $20 million of cash, even if the total consideration exceeds the fair value of 100 million shares. An entity applies extinguishment accounting (see Section 4.5.5) if (1) an exchange of a convertible debt instrument for shares (or cash and shares) occurs under terms that are different from the original conversion terms and (2) the exchange is outside the scope of the accounting requirements for induced conversions.

The guidance in U.S. GAAP does not clearly address whether inducement accounting applies to a conversion that meets the conditions in ASC 470-20-40-13 in situations in which the conversion feature has been bifurcated as a derivative instrument under ASC 815-15. In such circumstances, it may be acceptable to apply either inducement accounting (because of the lack of an explicit scope exception) or extinguishment accounting.

### 4.5.4.2 Recognition and Measurement

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-16</strong> If a convertible debt instrument is converted to equity securities of the debtor pursuant to an inducement offer (see paragraph 470-20-40-13), the debtor shall recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. The fair value of the securities or other consideration shall be measured as of the date the inducement offer is accepted by the convertible debt holder. That date normally will be the date the debt holder converts the convertible debt into equity securities or enters into a binding agreement to do so. Until the debt holder accepts the offer, no exchange has been made between the debtor and the debt holder. Example 1 (see paragraph 470-20-55-1) illustrates the application of this guidance.</td>
</tr>
<tr>
<td><strong>40-17</strong> The guidance in the preceding paragraph does not require recognition of gain or loss with respect to the shares issuable pursuant to the original conversion privileges of the convertible debt when additional securities or assets are transferred to a debt holder to induce prompt conversion of the debt to equity securities. In a conversion pursuant to original conversion terms, debt is extinguished in exchange for equity pursuant to a preexisting contract that is already recognized in the financial statements, and no gain or loss is recognized upon conversion.</td>
</tr>
</tbody>
</table>

Under ASC 470-20, when a conversion must be accounted for as an induced conversion, the issuer should recognize an inducement expense equal to the fair value of the consideration transferred (including the fair value of the additional securities issued and that of any other sweetener, such as cash, warrants, or other securities issued) in excess of the fair value of the securities issuable under the original conversion terms. No gain or loss is recognized for the securities that were issuable under the original conversion terms. Thus, in an induced conversion that involves only the issuance of additional shares, for example, the issuer may make the following accounting entry:

- Convertible debt
- Debt conversion expense (inducement loss)
- Equity — common stock
Although conversions in accordance with changed conversion terms are otherwise accounted for as debt extinguishments (see Section 4.5.5), paragraphs 22 and 25 of the Basis for Conclusions of FASB Statement 84 indicate that it would be inappropriate to record a debt extinguishment gain or loss related to the shares issuable under the original conversion terms in an induced conversion subject to ASC 470-20-40-13. Those paragraphs state, in part:

[ASC 470-20-25-12] states that no portion of the proceeds from the issuance of [traditional] convertible debt should be accounted for as attributable to the conversion feature. The amount recognized as a liability relating to convertible debt represents an obligation either to pay a stated amount of cash or to issue a stated number of shares of equity securities. The Board believes that the nature of that obligation does not change if an incentive is paid to a debt holder to induce the holder to exercise a right already held. Therefore, [ASC 470-20-40-13] requires no recognition of gain or loss with respect to the shares issuable pursuant to the original conversion privileges of the convertible debt when additional securities or assets are transferred to a debt holder to induce prompt conversion of the debt to equity securities. . . . The Board believes that an induced conversion transaction is . . . different from an extinguishment of debt transaction as described in [ASC 470-50-40-2], in which any preexisting contract between the debtor and the debt holder is effectively voided and the debt is extinguished pursuant to newly negotiated terms.

In paragraphs 23 and 28 of the Basis for Conclusions of Statement 84, the FASB explains the reason it included the requirement to recognize a cost for the additional consideration issued as follows:

Unlike a conversion pursuant to original terms, in an induced conversion transaction the enterprise issues securities or pays assets in excess of those provided in the preexisting contract between the parties. The Board believes that the enterprise incurs a cost when it gives up securities or assets not pursuant to a previous obligation and that the cost of those securities or assets should be recognized. . . . The Board . . . noted that, in all induced conversions of convertible debt described herein, the debtor corporation gives debt holders equity securities (or a combination of equity securities and other consideration) whose total fair value exceeds the value of the securities it was previously obligated to give upon conversion. The Board believes that a debtor's election to induce conversion, causing additional value to be given up, should result in recognition of the cost of that inducement.

The inducement expense is recognized as of the date the inducement offer is accepted by the convertible debt holder (i.e., generally the earlier of (1) the conversion date and (2) the date the holder enters into a binding agreement to convert), not as of the date the inducement offer is made. Paragraph 30 of the Basis for Conclusions of FASB Statement 84 states, in part:

The Board . . . considered whether a change in conversion privileges of a convertible debt instrument to induce prompt conversion should be recognized when the change is made, that is, when the inducement is offered to debt holders. The Board rejected that approach. Until the debt holder accepts the offer, no exchange has been made between the debtor and the debt holder. The Board concluded that the transaction should not be recognized until the inducement offer has been accepted by the debt holder.

Similarly, in the calculation of the inducement cost, the fair value of the securities or other consideration transferred as part of the inducement transaction is measured as of the date the inducement offer is accepted by the holder, not as of the date the inducement offer is made. If different holders accept the same offer on different dates, there may be multiple measurement dates. Paragraphs 31 and 32 of the Basis for Conclusions of FASB Statement 84 state, in part:

Some respondents stated that the fair value of a change in conversion privileges should be measured (but not recognized) as of the date the conversion inducement is offered. They reasoned that the fair value of the conversion inducement at the offer date is the basis for management's decision to make the offer and that the value as of that date is the best measure of the consideration paid.

The Board did not adopt that approach. The Board believes that the transaction should not be measured until the parties agree, that is, until the inducement offer has been accepted by the debt holder. The Board notes that in many cases the difference between the measurements of value of the inducement offer at the offer date and the acceptance date will be minimal due to the normal structure of conversion inducement offers and the requirement in [ASC 470-20-40-13] that the inducement be offered for a limited period of time. However, in circumstances involving differences in values, the Board believes the fair value as of the acceptance date is the appropriate measure because that is the value of the inducement which presumably causes the transaction to occur.
Because the inducement expense recognized must equal the fair value of the additional securities issued upon conversion regardless of the convertible debt’s net carrying amount and the total fair value of the consideration paid on conversion, some accounting outcomes may be economically counterintuitive. For example, an offer that is settled entirely in cash might result in the recognition of a debt extinguishment gain, whereas an offer of equal economical value that is settled in shares might result in the recognition of an inducement loss. Further, the amount credited to equity to reflect the shares issued may exceed their fair value. As noted in Robert Sprouse’s dissent to FASB Statement 84, the requirement to recognize and measure an inducement expense does not “distinguish between induced conversions made under [the following two] sets of facts and circumstances: (a) debt convertible into equity securities whose market values are greater than the conversion price (refer to [ASC 470-20-55-3 and 55-4]) and (b) debt convertible into equity securities whose market values are less than the conversion price (refer to [ASC 470-20-55-6 and 55-7]).”

Example 4-3

**Induced Conversion of Convertible Debt for Total Consideration Less Than the Debt’s Carrying Amount**

Issuer A has outstanding convertible bonds that it accounts for as traditional convertible debt under ASC 470-20. Their net carrying amount is $1 million. The original conversion price was $20 (i.e., the issuer would deliver 50,000 shares upon conversion). To induce prompt conversion, A reduces the conversion price to $16 for a limited period (i.e., 62,500 shares), and the holders accept the offer. The current stock price is $15. Accordingly, the fair value of the securities issuable under the original conversion terms was $750,000 (i.e., 50,000 × $15) and the fair value of the securities issuable under the revised conversion terms is $937,500 (i.e., 62,500 × $15). Because the consideration issuable under the changed conversion privileges exceeds the consideration under the original terms, A recognizes an inducement loss under ASC 470-20 equal to the fair value of the additional shares, $187,500 (i.e., 12,500 × $15). However, if A had repurchased the shares for a cash payment of $937,500 instead of issuing shares worth $937,500, it would have recognized a debt extinguishment gain of $62,500 (i.e., $1,000,000 – $937,500).

4.5.4.3 Illustrations

**Example 1: Induced Conversions of Convertible Securities**

- **Case A**: Reduced conversion price for conversion before determination date, increase in bond fair value.
- **Case B**: Reduced conversion price for conversion before determination date, decrease in bond fair value.

**Case A**: Reduced Conversion Price for Conversion Before Determination Date — Bond Fair Value Increased

On January 1, 19X4, Entity A issues a $1,000 face amount 10 percent convertible bond maturing December 31, 20X3. The carrying amount of the bond in the financial statements of Entity A is $1,000, and it is convertible into common shares of Entity A at a conversion price of $25 per share. On January 1, 19X6, the convertible bond has a fair value of $1,700. To induce convertible bondholders to convert their bonds promptly, Entity A reduces the conversion price to $20 for bondholders that convert before February 29, 19X6 (within 60 days).
55-4 Assuming the market price of Entity A's common stock on the date of conversion is $40 per share, the fair value of the incremental consideration paid by Entity A upon conversion is calculated as follows for each $1,000 bond that is converted before February 29, 19X6.

| Description                                                      | Amount  
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of securities issued</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Value of securities issuable pursuant to original conversion</td>
<td>$ 1,600</td>
</tr>
<tr>
<td>Fair value of incremental consideration</td>
<td>$  400</td>
</tr>
</tbody>
</table>

(a) Value of securities issued to debt holders is computed as follows:

- Face amount: $ 1,000
- New conversion price: $20 per share
- Number of common shares issued upon conversion: 50 shares
- Price per common share: $40 per share
- Value of securities issued: $ 2,000

(b) Value of securities issuable pursuant to original conversion privileges is computed as follows:

- Face amount: $ 1,000
- Original conversion price: $25 per share
- Number of common shares issuable pursuant to original conversion privileges: 40 shares
- Price per common share: $40 per share
- Value of securities issuable pursuant to original conversion: $ 1,600

55-5 Therefore, Entity A records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

- Convertible debt: $ 1,000
- Debt conversion expense: $ 400
- Common stock: $ 1,400

Case B: Reduced Conversion Price for Conversion Before Determination Date — Bond Fair Value Decreased

55-6 On January 1, 19X1, Entity B issues a $1,000 face amount 4 percent convertible bond maturing December 31, 20X0. The carrying amount of the bond in the financial statements of Entity B is $1,000, and it is convertible into common shares of Entity B at a conversion price of $25. On June 1, 19X4, the convertible bond has a fair value of $500. To induce convertible bondholders to convert their bonds promptly, Entity B reduces the conversion price to $20 for bondholders that convert before July 1, 19X4 (within 30 days).
55-7 Assuming the market price of Entity B's common stock on the date of conversion is $12 per share, the fair value of the incremental consideration paid by Entity B upon conversion is calculated as follows for each $1,000 bond that is converted before July 1, 19X4.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of securities issued&lt;br&gt;(a)</td>
<td>$ 600</td>
</tr>
<tr>
<td>Value of securities issuable pursuant to original conversion privileges&lt;br&gt;(b)</td>
<td>$ 480</td>
</tr>
<tr>
<td>Fair value of incremental consideration</td>
<td>$ 120</td>
</tr>
</tbody>
</table>

\(a\) Value of securities issued to debt holders is computed as follows:

\[ \text{Face amount} \div \text{New conversion price} \times \text{Number of common shares issued upon conversion} \times \text{Price per common share} = \text{Value of securities issued} \]

\(b\) Value of securities issuable pursuant to original conversion privileges is computed as follows:

\[ \text{Face amount} \div \text{Original conversion price} \times \text{Number of common shares issuable pursuant to original conversion privileges} \times \text{Price per common share} = \text{Value of securities issuable pursuant to original conversion} \]

55-8 Therefore, Entity B records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible debt</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Debt conversion expense</td>
<td>$ 120</td>
</tr>
<tr>
<td>Common stock</td>
<td>$ 1,120</td>
</tr>
</tbody>
</table>

55-9 The same accounting would apply if, instead of reducing the conversion price, Entity B issued shares pursuant to a tender offer of 50 shares of its common stock for each $1,000 bond surrendered to the entity before July 1, 19X4. See paragraph 470-20-40-14.

### 4.5.5 Extinguishments

ASC 405-20 and ASC 470-50 provide the accounting requirements related to debt extinguishments. While a detailed discussion of that guidance is beyond the scope of this Roadmap, the sections below briefly summarize its application to convertible debt.
4.5.5.1 Scope

ASC 405-20

40-1 Unless addressed by other guidance (for example, paragraphs 405-20-40-3 through 40-4 or paragraphs 606-10-55-46 through 55-49), a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
   1. Delivery of cash
   2. Delivery of other financial assets
   3. Delivery of goods or services
   4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this Subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

ASC 470-50

05-1 This Subtopic discusses the accounting for all extinguishments of debt instruments, except debt that is extinguished through a troubled debt restructuring (see Subtopic 470-60) or a conversion of debt to equity securities of the debtor pursuant to conversion privileges provided in terms of the debt at issuance (see Subtopic 470-20).

15-2 The guidance in this Subtopic applies, in part, to the following transactions and activities:

a. Extinguishments of debt effected by issuance of common or preferred stock, including redeemable and fixed-maturity preferred stock, that do not represent the exercise of a conversion right contained in the terms of the debt at issuance.

15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

a. Conversions of debt into equity securities of the debtor pursuant to conversion privileges provided in the terms of the debt at issuance. Additionally, the guidance in this Subtopic does not apply to conversions of convertible debt instruments pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. Guidance on conversions of debt instruments (including induced conversions) is contained in paragraphs 470-20-40-13 and 470-20-40-15.

b. Extinguishments of debt through a troubled debt restructuring. (See Section 470-60-15 for guidance on determining whether a modification or exchange of debt instruments is a troubled debt restructuring. If it is determined that the modification or exchange does not result in a troubled debt restructuring, the guidance in this Subtopic shall be applied.)

c. Transactions entered into between a debtor or a debtor’s agent and a third party that is not the creditor.
Extinguished debt should be derecognized (i.e., removed from the statement of financial position). In a manner similar to other debt instruments, a convertible debt instrument is considered extinguished when either of the two conditions in ASC 405-20-40-1 is met; that is, it would be considered extinguished if the issuer (1) “pays the creditor and is relieved of its obligation for the liability” or (2) “is legally released from being the primary obligor under the liability.” In cases in which the debtor has been relieved of its obligation, examples of debt extinguishment transactions include:

- The debtor repays the principal amount and any accrued interest on the debt's contractual maturity date.
- The debtor settles the debt after exercising a call or prepayment feature embedded in the debt.
- The debtor settles the debt after the investor exercises a put feature embedded in the debt.
- The debtor repurchases outstanding debt securities in a public market for the debt.

Note that debt is considered to be extinguished if the issuer buys it back even if the issuer intends or expects to reissue the debt (such as treasury bonds). Conversely, debt is not considered to be extinguished solely because the issuer intends, expects, or has committed to settling it by paying the creditor at a future date. For example, debt would not be considered extinguished before settlement even if the issuer had provided the holder with an irrevocable notice that it is exercising a call or prepayment feature embedded in the debt. However, an irrevocable notice to repay debt before its maturity could affect its current versus noncurrent classification.

The general approach to accounting for debt extinguishments is to recognize currently any difference between the reacquisition price of the debt and its net carrying amount as a gain or loss in net earnings (see Section 4.5.5.2). This approach applies not just to circumstances in which the issuer either (1) repays the debt by transferring cash or other assets or (2) is otherwise legally released from being the primary obligor but also to situations in which the terms have been modified and the new terms are substantially different from those of the original (see Section 4.5.6). Further, in certain circumstances, debt extinguishment accounting applies to conversions or exchanges of debt into the issuer’s equity shares. Examples include:

- A conversion that occurs upon the issuer’s exercise of a call option if the instrument did not contain a substantive conversion feature as of its issuance date (see Section 4.5.3).
- A conversion that occurs in accordance with changed conversion privileges that does not meet the criteria for induced conversion accounting (see Section 4.5.4).
- A conversion that occurs in accordance with the original terms of a conversion feature that represents a share-settled redemption option (see Section 2.4).

Paragraph 19 of APB Opinion 26 (this paragraph was not codified) notes that the “accounting for [debt extinguishment] transactions should be the same regardless of the means used to achieve the extinguishment.” Therefore, in accordance with ASC 470-50-15-2(a), a share settlement should be accounted for as a debt extinguishment, rather than a conversion, if the issuance of shares economically represents a payment to the creditor in full settlement of the debt in a manner similar to the delivery of financial assets under ASC 405-20-40-1(a). Accordingly, debt extinguishment accounting applies to:

- The settlement of debt through the issuance of shares if the issuer is using its own shares as a means of currency to settle the debt’s value (e.g., the number of shares delivered is determined to have a value equal to the monetary amount of the debt obligation).
- The conversion of debt into a variable number of shares in accordance with a share-settled redemption or indexation feature (see Section 2.4).
Further, it may be appropriate to apply debt extinguishment accounting to conversions of convertible debt for which the conversion feature was separated as a derivative instrument under ASC 815-15. See further discussion in Appendix B.

The general approach to accounting for debt extinguishments does not apply to traditional convertible debt in the following circumstances:

- A conversion that occurs under the conversion privileges contained in the original terms of the instrument (see Section 4.5.2), unless other guidance takes precedence.
- A conversion that occurs upon the issuer’s exercise of a call option if the instrument contained a substantive conversion feature as of its issuance date (see Section 4.5.3), unless other guidance takes precedence.
- A conversion that reflects changes to the conversion privileges contained in the terms at inception if the criteria for induced conversion accounting are met (see Section 4.5.4).
- A TDR as defined in ASC 470-60 (see Section 4.5.7).
- An exchange of debt instruments (including an exchange involving contemporaneous exchanges of cash between the same debtor and creditor) if the terms are not substantially different (see Section 4.5.6).
- Certain debt extinguishment transactions involving related parties (see Section 4.5.5.3).

Further, the general approach to accounting for debt extinguishments does not apply to:

- A conversion or extinguishment of convertible debt with a BCF that was separated in accordance with the guidance in ASC 470-20 (see Section 7.6).
- A conversion or extinguishment of convertible debt that was separated into liability and equity components under the CCF guidance in ASC 470-20 (see Section 6.5).

Although a traditional convertible debt instrument does not contain any equity component on the issuance date, the issuer may be required to subsequently recognize a separate component within equity if it (1) modifies or exchanges the convertible debt instrument in a transaction that does not result in extinguishment but includes an increase in the fair value of the embedded conversion option (see Section 4.5.6) or (2) reclassifies an embedded conversion feature that was previously classified as an embedded derivative liability to equity (see Section 6.4 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity). In these circumstances, any subsequent extinguishment of the convertible debt instrument includes extinguishment of both the liability for the convertible debt instrument and the conversion option for which an amount is classified in equity. It is therefore appropriate to allocate the total reacquisition price of the debt to the two components (to calculate the extinguishment gain or loss on the liability component). This treatment is similar to how an issuer accounts for the extinguishment of a convertible debt instrument that contained a BCF (see Section 7.6.2); however, the amount that an issuer allocates from the reacquisition price to the equity component would not be the intrinsic value of the conversion option on the date of extinguishment. Rather, if the equity component resulted from the reclassification of an embedded conversion feature from a derivative liability to equity, the amount allocated to the reacquisition of the equity component would be equal to the fair value of the conversion option on the date of the extinguishment in accordance with ASC 815-15-40-4.

The Codification does not specifically address how to allocate the reacquisition price for traditional convertible debt if the equity component resulted from a modification or exchange that increased the fair value of the conversion feature. Generally, the amount that was previously recognized for that equity component would be allocated to its reacquisition. Regardless of the approach applied, the amount
allocated to the equity component should not result in a gain or loss. (ASC 260-10-S99-2 does not apply to the settlement of the equity component if the convertible debt instrument provided for conversion into the issuer’s common stock.)

4.5.5.2 Recognition and Measurement

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| **40-2** A difference between the reacquisition price of debt and the net carrying amount of the extinguished debt shall be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. Gains and losses shall not be amortized to future periods. If upon extinguishment of debt the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges shall be given appropriate accounting recognition. Moreover, extinguishment transactions between related entities may be in essence capital transactions.

**40-2A** In an early extinguishment of debt for which the fair value option has been elected in accordance with Subtopic 815-15 on embedded derivatives or Subtopic 825-10 on financial instruments, the net carrying amount of the extinguished debt shall be equal to its fair value at the reacquisition date. In accordance with paragraph 825-10-45-6, upon extinguishment an entity shall include in net income the cumulative amount of the gain or loss previously recorded in other comprehensive income for the extinguished debt that resulted from changes in instrument-specific credit risk.

**40-3** In an early extinguishment of debt through exchange for common or preferred stock, the reacquisition price of the extinguished debt shall be determined by the value of the common or preferred stock issued or the value of the debt — whichever is more clearly evident.

**Extinguishment of Convertible Debt**

**40-4** The extinguishment of convertible debt does not change the character of the security as between debt and equity at that time. Therefore, a difference between the cash acquisition price of the debt and its net carrying amount shall be recognized currently in income in the period of extinguishment as losses or gains.

**ASC 470-50 — Glossary**

**Net Carrying Amount of Debt**

Net carrying amount of debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.

**Reacquisition Price of Debt**

The amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities.

Under the general approach to debt extinguishment accounting, any difference between the reacquisition price of debt and its net carrying amount is recognized in net earnings as a debt extinguishment gain or loss. Thus, for example, the issuer may make the following accounting entry if the cash reacquisition price exceeds the net carrying amount:

```
Convertible debt
Debt extinguishment loss
Cash
```

The reacquisition price is the monetary amount of consideration paid to extinguish the debt (e.g., the amount of cash paid or the fair value of the instruments, goods, or services transferred). When a
conversion or exchange of debt for the issuer’s equity shares is accounted for as a debt extinguishment, the reacquisition price is the amount that is a more clearly evident measure of the fair value of either (1) the shares issued or (2) the debt extinguished (see ASC 470-20-40-3). However, we believe that if the issuer delivers a variable number of shares whose value is computed to equal a fixed monetary amount based on an average stock price (e.g., the most recent 20-day volume-weighted average price on the conversion date) rather than the stock price on the conversion date, by analogy to ASC 480-10-55-22, no gain or loss should be recognized for a difference between (1) the conversion-date fair value of the shares delivered and (2) the fixed monetary amount, irrespective of whether the convertible instrument is within the scope of ASC 480-10.

The net carrying amount of the debt accounted for by using the interest method in ASC 835-30 is the debt’s current amortized cost (i.e., the amount due at maturity adjusted for any remaining unamortized premium or discount and remaining unamortized debt issuance cost as of the date of extinguishment determined by using the interest method). The net carrying amount includes any interest accrued to the date of extinguishment even if it is forfeited (i.e., it is not reversed; see Section 4.5.2.1).

If an entity accounts for the debt at fair value by using the fair value option in ASC 825-10, the determination of the extinguishment gain or loss should be based on the fair value of the carrying amount as of the date of extinguishment (i.e., the fair value on the reacquisition date is the net carrying amount of the extinguished debt). As indicated in ASC 470-50-40-2A, “upon extinguishment an entity shall include in net income the cumulative amount of the gain or loss previously recorded in other comprehensive income for the extinguished debt that resulted from changes in instrument-specific credit risk.”

If the convertible debt has an equity component, allocation of the reacquisition price between the liability and equity components is required. See further discussion in Sections 4.5.5.1, 6.5, and 7.6.2.

### 4.5.5.3 Extinguishments Between Related Parties

In accordance with ASC 470-50-40-2, “extinguishment transactions between related entities may be in essence capital transactions.” This guidance has generally been interpreted to suggest that there is a rebuttable presumption that debt extinguishments with related parties (e.g., the investor, before conversion, is a significant shareholder, part of management, or an affiliate of the issuer) that benefit the borrower are capital transactions unless there is substantive evidence that the entity would have obtained the same economic outcome in an arm’s length transaction. For instance, if the issuer settles identical debt instruments with a related party and third-party investors, and the settlement terms (e.g., the reacquisition price) are the same for all parties, the extinguishment transaction with the related party should not be treated as a capital transaction.

In his remarks at the 2010 AICPA Conference on Current SEC and PCAOB Developments, then SEC Professional Accounting Fellow Sagar Teotia explained that the SEC staff expects issuers to determine whether an extinguishment transaction with a related party represents a capital transaction. Noting that “the staff has not formed any bright line views on these types of transactions and analyzes these questions individually on a specific facts and circumstances basis,” Mr. Teotia provided examples of the questions the staff has asked registrants related to the analysis:

- What was the role of the related party in the transaction?
- Why would the related party accept the Company’s offer which resulted in the related party accepting common stock that was significantly lower in value than the carrying value of the debt?
- Was the substance of the arrangement a forgiveness of debt that was owed to a related party?
Mr. Teotia emphasized that the “staff believes that a full analysis is required in assessing the substance of these types of transactions. Accordingly, the staff would expect that registrants consider all of the facts and circumstances and related party relationships in a particular transaction when making its accounting assessment.”

### 4.5.6 Modifications and Exchanges

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<td>40-18</td>
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If an issuer modifies or exchanges an outstanding convertible debt instrument, it should assess whether the transaction should be accounted for as either a modification or an extinguishment of the original instrument under ASC 470-50. While a detailed discussion of these requirements is beyond the scope of this Roadmap, this section provides a brief overview of the requirements in ASC 470-50 that apply to modifications and exchanges of convertible debt.

The guidance on modifications and exchanges in ASC 470-50 does not apply to:

- Conversions that occur under the original terms of the instrument (see Section 4.5.2).
- Conversion price adjustments that are made in accordance with the original terms of the instrument. For example, an adjustment under a down-round protection feature would not be evaluated in accordance with the requirements for modifications and exchanges in ASC 470-50. Instead, the issuer should evaluate such provisions under other GAAP (e.g., for a discussion of how to evaluate whether the instrument contains an embedded derivative that must be separated under ASC 815-15, see Section 2.3; for a discussion of how to evaluate whether the instrument contains a contingent BCF that should be monitored and potentially recognized under ASC 470-20, see Section 7.5).
- Changes to the terms of the conversion privileges that represent an induced conversion under ASC 470-20 (see Section 4.5.4).
- Modifications and exchanges that occur on the instrument’s maturity date. By analogy to ASC 470-20-30-19 (see Section 7.3.2.2.5), the guidance in ASC 470-50 on modifications and exchanges of debt instruments does not apply to modifications or exchanges that occur on the original contractual maturity date of an outstanding instrument. Instead, if a debt instrument is issued as consideration on the original maturity date of another debt instrument, the issuer reflects a repayment of the debt at maturity in return for noncash consideration (i.e., the new debt instrument), which results in the extinguishment of the original debt instrument. Accordingly, the issuer recognizes (1) the new debt instrument at fair value and (2) the difference between this amount and the net carrying amount of the extinguished debt as an extinguishment gain or loss (see Section 4.5.5.2).
- TDRs (see Section 4.5.7).
- Announcements of intent. For example, as indicated in ASC 470-50-55-9(a), ASC 470-50 does not apply to an “announcement of intent by the debtor to call a debt instrument at the first call date.”
• Transactions between the issuer (or its agent) and a party other than the debt holder (or its agent). Thus, as indicated in ASC 470-50-55-9(c), ASC 470-50 does not apply to “[a]n agreement with a creditor that a debt instrument issued by the debtor and held by a different party will be redeemed.”

• Transactions among debt holders unless funds pass through the debtor or its agent (see ASC 470-50-40-7 and ASC 470-50-55-6).

In accordance with ASC 470-50-40-9 and ASC 470-50-55-8, respectively, the requirements for modifications and exchanges in ASC 470-50 apply to the following transactions unless otherwise exempted:

• “Transactions involving contemporaneous exchanges of cash between the same debtor and creditor in connection with the issuance of a new debt obligation and satisfaction of an existing debt obligation by the debtor.”

• “[T]ransactions in which the terms of a debt instrument are modified through execution of a binding contract between the debtor and creditor that requires a debt instrument to be redeemed at a future date for a specified amount.” For example, a binding contract between a debtor and creditor to settle the debt one year before the contractual maturity date represents a modification of the debt terms that should be evaluated under ASC 470-50. Conversely, the debtor’s announcement of an intent to settle the debt one year before its contractual maturity date is not evaluated as a modification of the terms unless there is a binding contract to do so.

Although ASC 470-50-40-10 does not specifically address modifications and exchanges of instruments with mandatory conversion features (e.g., the automatic conversion of convertible debt into the issuer’s shares upon the occurrence of a contingent event), its guidance on modifications and exchanges that involve embedded conversion options can be applied by analogy to modifications and exchanges of instruments with mandatory conversion features.

In a manner consistent with the guidance in ASC 470-50-40-6, an exchange or modification of an outstanding debt instrument is accounted for as an extinguishment (see Section 4.5.5) of that instrument only if the original and new terms are substantially different. Otherwise, the modification or exchange is accounted for as a modification of the original instrument. Under ASC 470-50-40-10, the terms are considered substantially different if any of the following three circumstances exist:

• The “present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument.” The cash flows are discounted by using the effective interest rate of the original instrument. (A change in the fair value of an embedded conversion option is not treated as a cash flow in applying this test.)

• The “modification or an exchange affects the terms of an embedded conversion option” and “the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange . . . is at least 10 percent of the carrying amount of the original debt instrument immediately before the modification or exchange.” (This guidance does not apply, however, if the conversion option is bifurcated as an embedded derivative before the modification, after the modification, or both.)

• The “modification or an exchange of debt instruments adds a substantive conversion option or eliminates a conversion option that was substantive at the date of the modification or exchange.” (This guidance does not apply, however, if the conversion option is bifurcated as an embedded derivative.) For a discussion of how to assess whether an embedded conversion option is substantive, see Section 4.5.3.2.
If the original and new terms are considered substantially different, the original instrument is accounted for as being extinguished (see Section 4.5.5). Accordingly, the issuer recognizes (1) the new or modified debt instrument at its fair value and (2) a debt extinguishment gain or loss related to the original instrument to reflect the difference between the previous net carrying amount and the consideration exchanged (i.e., the fair value of the new debt instrument). Any fee payments made by the debtor or received by the creditor are included in the debt extinguishment gain or loss, and any third-party costs directly related to the modification or exchange are treated as debt issuance costs of the newly recognized instrument. The issuer may also need to consider, for example, whether it is required to apply the accounting guidance for CCFs or BCFs to the new instrument (see Chapters 6 and 7) even if that guidance did not previously apply. In addition, a new date would be established for the issuer’s election of the fair value option (see Section 2.5 for a discussion of when the fair value option may be applied to a convertible debt instrument).

If the original and new terms are considered not substantially different, the original instrument is accounted for as being modified. Accordingly, the issuer adjusts the effective interest rate on the basis of (1) the carrying amount of the original debt instrument, which is reduced if the modification or exchange causes an increase (but not a decrease) in the fair value of an embedded conversion option, and (2) the revised cash flows. Such a reduction in the carrying amount of the debt is recorded against APIC (i.e., a debit to “Debt discount” and a credit to “Equity — APIC”). There is no recognition of (1) a decrease in the fair value of the embedded conversion option that results from the modification or exchange or (2) a change in the instrument’s fair value that is not attributable to the modification or exchange. Any fee payments made by the debtor or received by the creditor are recognized in the basis of the modified instrument, and any third-party costs directly related to the modification or exchange are expensed as incurred. Because the original and new terms are considered not substantially different, the issuer is precluded from recognizing a BCF or reassessing an existing BCF upon the modification or exchange (see Section 7.6.3).

### 4.5.7 Troubled Debt Restructurings

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<td><strong>Troubled Debt Restructuring</strong></td>
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<td>A restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider.</td>
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If an issuer modifies or exchanges an outstanding convertible debt instrument, it should assess whether the transaction should be accounted for as a TDR under ASC 470-60. While a detailed discussion of the requirements in ASC 470-60 is beyond the scope of this Roadmap, this section provides a brief overview of the requirements that apply to TDRs of convertible debt.

In a manner consistent with the guidance in ASC 470-60-15-5, a modification or exchange of debt would be considered a TDR if “the creditor [i.e., holder] for economic or legal reasons related to the debtor’s [i.e., issuer’s] financial difficulties grants a concession to the debtor [i.e., issuer] that it would not otherwise consider.” Accordingly, ASC 470-60-55-5 indicates that for a modification or exchange to qualify as a TDR, the answer to both of the following questions must be yes:

- “Is the debtor experiencing financial difficulty (see paragraphs 470-60-55-7 through 55-9)?”
- “Has the creditor granted a concession (see paragraphs 470-60-55-10 through 55-14)?”
Generally, ASC 470-60-35 requires the following treatment for a modification or exchange of convertible debt that is accounted for as a TDR:

- If the issuer transfers cash or other assets to settle the convertible debt in full, the issuer recognizes a restructuring gain equal to the excess of (1) the carrying amount of the debt over (2) the fair value of the assets transferred, adjusted for any direct restructuring costs. A difference between the fair value and the carrying amount of the assets transferred represents a gain or loss on the transfer of those assets.

- If the issuer grants or issues an equity interest (e.g., equity shares) to settle the debt in full, the equity interest issued is recognized at its fair value less any legal fees and other direct costs incurred in granting the equity interest. The difference between that amount and the carrying amount of the debt is recognized as a restructuring gain after adjustment for any other direct restructuring costs.

- If the terms of the debt are modified, the accounting depends on whether the carrying amount exceeds the total future undiscounted cash payments specified by the new terms:
  - If the carrying amount is equal to or less than the total future undiscounted cash payments specified by the new terms, the issuer accounts for the modification prospectively by adjusting the effective interest. Any direct restructuring costs are recognized immediately.
  - If the carrying amount exceeds the total future undiscounted cash payments specified by the new terms, the issuer reduces the carrying amount of the debt to an amount equal to those payments and recognizes a restructuring gain equal to the reduction, adjusted for any direct restructuring costs. (Note, however, that a gain should not be recognized if the undiscounted, maximum total future cash payments, including contingently payable amounts, could exceed the carrying amount.)

- If the restructuring represents a combination of the types described above (i.e., it involves both an asset transfer or grant of equity interests and a modification of the debt terms), the issuer should reduce the carrying amount of the debt by the fair value of any assets transferred and equity interests granted before applying the requirements previously discussed for TDRs that involve a modification of the debt terms.

If the TDR is with a related party, the issuer should consider whether the restructuring represents a capital transaction (see Section 4.5.5.3).

### 4.6 Presentation and Disclosure

#### 4.6.1 Presentation on a Classified Balance Sheet

ASC 210-10-45 contains the general requirements related to an entity’s classification of assets and liabilities as either current or noncurrent in a classified balance sheet, and ASC 470-10-45 contains specific requirements related to the issuer’s classification of debt obligations, including convertible debt, as either current or noncurrent. Under those requirements, current liabilities generally include convertible debt obligations for which a payment of cash or other current assets or the creation of current liabilities could be required within 12 months (or the entity’s operating cycle, if longer) of the balance sheet date. Examples of such liabilities would include:

- Convertible debt that is scheduled to mature within one year (or operating cycle, if longer) after the balance sheet date.

- Any portion of long-term convertible debt that is scheduled to mature within one year (or operating cycle, if longer) after the balance sheet date (e.g., the current portion of an amortizing long-term debt obligation for which the principal amount is paid down over the obligation’s life).
• Convertible debt that is repayable on demand or puttable by the holder within one year (or operating cycle, if longer) after the balance sheet date (see ASC 470-10-45-9 and 45-10), including convertible debt that is only contingently puttable if the contingency has been met.

• Long-term convertible debt that became repayable on demand or within one year (or operating cycle, if longer) after the balance sheet date because of a covenant violation that occurred as of the balance sheet date or before or as of the issuance of the financial statements (see ASC 470-10-45-11).

Generally, the holder’s conversion option does not affect the classification of traditional convertible debt as current or noncurrent if it must be settled by the delivery of the issuer’s equity shares.

Note that short-term obligations that are expected to be refinanced on a long-term basis are classified as noncurrent if the debtor has both the intent and ability to refinance the obligation on a long-term basis and certain qualifying criteria are met (see ASC 470-10-45-14).

4.6.2 Presentation of Issuance Costs

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| 45-1A Debt issuance costs related to a note shall be reported in the balance sheet as a direct deduction from the face amount of that note. Debt issuance costs shall not be classified as a deferred charge. .....

Generally, ASC 835-30 (as amended by ASU 2015-03) requires issuance costs (see Section 3.5.3) that are attributable to the initial sale of a debt instrument, including traditional convertible debt subject to ASC 470-20, to be presented as a direct deduction from the instrument’s face amount. Thus, in a manner similar to a debt discount, such costs are offset against the associated proceeds in the determination of the instrument’s initial net carrying amount. Subsequently, debt issuance costs are amortized as additional interest expense over the life of the debt. Historically, U.S. GAAP permitted issuers to present debt issuance costs as deferred charges, but after the adoption of ASU 2015-03, this accounting is no longer acceptable for recognized debt instruments.

4.6.3 EPS Calculation

This section provides an overview of the issuer’s calculation of EPS for traditional convertible debt. For additional discussion, see Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.

4.6.3.1 Basic EPS

Provided that a traditional convertible debt instrument does not meet the definition of a participating security, the impact on basic EPS is attributable to (1) a reduction of the numerator (i.e., net income) resulting from the recognition of interest expense or an adjustment to the numerator resulting from the recognition of a gain or loss upon extinguishment and (2) an increase in the denominator once the convertible debt instrument has been settled in exchange for common stock (i.e., an increase in the weighted-average common shares outstanding calculated from the date the security is exchanged for common stock). If a traditional convertible debt instrument meets the definition of a participating security, the entity must apply the two-class method to calculate basic EPS (see Chapter 5 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share).
**4.6.3.2 Diluted EPS**

Provided that a traditional convertible debt instrument does not represent a participating security, the if-converted method is used to reflect the impact of the embedded conversion option on diluted EPS. If a traditional convertible debt instrument meets the definition of a participating security, the issuer must apply the more dilutive of the if-converted method or the two-class method to calculate diluted EPS (see Chapter 5 of Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share*).

Under the if-converted method, an entity must adjust both the numerator and denominator. Since an entity using the if-converted method assumes that a convertible debt instrument was converted into common shares at the beginning of the reporting period (or the date of issuance, if later), the numerator is adjusted to reverse any recognized interest expense (including any amortization of discounts), net of tax. The common shares issuable upon conversion are added to the denominator on the basis of the most favorable conversion terms available to the holder. Except in the case of certain contingently convertible debt instruments, the if-converted method, if dilutive, must be applied even if the embedded conversion option is out-of-the-money. The guidance on contracts that may be settled in cash or stock is not relevant to traditional convertible debt instruments since the issuer must satisfy any conversion by issuing common shares. See Section 4.4 of Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share* for further discussion of the if-converted method. Section 4.9.3 of Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share* discusses the application of the if-converted method to year-to-date calculations of diluted EPS.

Special considerations apply if:

- An induced conversion occurs (see Section 4.6.3.3 below).
- The conversion feature is nonsubstantive at inception and becomes exercisable only upon the exercise of a call option (see Section 4.6.3.4).
- The convertible debt represents a participating security to which the two-class method applies (see Chapter 5 of Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share*).
- The conversion feature is contingent (see Section 4.4.3 of Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share*).
- The embedded conversion option is separated as a derivative under ASC 815-15 (see Section 6.6.3 of Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share*).
- The issuer has elected the fair value option in ASC 825-10 (see Section 6.6.4 of Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share*).
- The convertible debt contains an embedded put or call option (see Section 6.6.5 of Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share*).

**4.6.3.3 Induced Conversions**

Upon an induced conversion of a convertible debt instrument (see Section 4.5.4), the issuer will not be required to adjust the calculation of basic EPS because the loss on inducement will already be reflected in the numerator.

In the calculation of diluted EPS under the if-converted method, a recognized inducement loss should be added back to the numerator. By analogy to the guidance in ASC 260-10-S99-2, when an SEC registrant effects an induced conversion of only a portion of a class of outstanding convertible debt instruments, the entity should, in determining whether the if-converted method is dilutive for a financial reporting period, consider the convertible debt instruments converted in accordance with an inducement offer separately from other convertible debt instruments of the same class that are not converted under such an offer.
Connecting the Dots

When convertible debt instruments are converted during a financial reporting period in accordance with an inducement offer, an entity that is using the if-converted method assumes that the instruments were converted at the beginning of the reporting period, or on the date of issuance if later, on the basis of the stated conversion terms. Because the numerator adjustment will reflect a reversal of the additional consideration provided under the inducement offer, the application of the if-converted method during a period in which an induced conversion has occurred will typically be antidilutive for the convertible debt instruments that were converted under such an offer.

In the calculation of diluted EPS under the treasury stock method for Instruments C and X (see Chapter 6), any recognized inducement loss should not be added back to (reversed from) the numerator.

4.6.3.4 Nonsubstantive Conversion Options

As discussed in Section 4.5.3, ASC 470-20-40-5 addresses the accounting for an issuance of common shares “to settle a debt instrument (pursuant to the instrument's original conversion terms) that became convertible [only] upon the issuer's exercise of a call option.” According to this guidance, the issuer must evaluate whether the debt instrument contained a substantive conversion feature as of its issuance date. If the debt instrument did not contain a substantive conversion feature as of its issuance date, any settlement through the issuance of common stock should not be treated as a conversion for accounting purposes but should be accounted for as a debt extinguishment, with a gain or loss recognized in earnings (i.e., the fair value of the common shares issued would equal the reacquisition price that is compared with the carrying amount to determine the gain or loss upon extinguishment).

Although it is not common for debt instruments to contain nonsubstantive embedded conversion features, if such a feature exists and it can be exercised by the holder only if the issuer exercises an option to call the debt before its maturity, the issuer is not required to apply the if-converted method to calculate diluted EPS in all financial reporting periods. Rather, since the entity controls the ability to avoid issuing common shares by virtue of its right not to exercise the call option, the diluted EPS implications, if any, should take into account the fact that the entity controls exercise of the call option. If, however, the holder of a debt instrument has the right to exercise a conversion feature that is considered nonsubstantive as of the issuance date, the issuer should evaluate the conversion feature as an embedded put option. The same accounting would apply if the conversion feature only became substantive after the issuance date. In both circumstances, the put option is treated in the same manner as stock-settled debt and the if-converted method applies (as discussed in Section 6.5 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share).

4.6.4 Disclosure

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-1</strong> For disclosures about securities as part of equity disclosures, see Section 505-10-50.</td>
</tr>
<tr>
<td><strong>50-2</strong> For disclosures about securities in relationship to earnings per share (EPS) disclosures, see paragraph 260-10-50-1(c).</td>
</tr>
</tbody>
</table>
Chapter 4 — Traditional Convertible Debt

**ASC 505-10**

50-3 An entity shall explain, in summary form within its financial statements, the pertinent rights and privileges of the various securities outstanding. Examples of information that shall be disclosed are dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares or terms that may change conversion or exercise prices (excluding standard antidilution provisions). An entity shall disclose within its financial statements the number of shares issued upon conversion, exercise, or satisfaction of required conditions during at least the most recent annual fiscal period and any subsequent interim period presented. An entity also shall disclose within the financial statements actual changes to conversion or exercise prices that occur during the reporting period (excluding changes due to standard antidilution provisions).

50-6 To comply with the general disclosure requirements of paragraph 505-10-50-3, the significant terms of the conversion features of the contingently convertible security shall be disclosed to enable users of financial statements to understand the circumstances of the contingency and the potential impact of conversion. Quantitative and qualitative terms of the contingently convertible security, disclosure of which would be helpful in understanding both the nature of the contingency and the potential impact of conversion, include all of the following:

a. Events or changes in circumstances that would cause the contingency to be met and any significant features necessary to understand the conversion rights and the timing of those rights (for example, the periods in which the contingency might be met and the securities may be converted if the contingency is met)

b. The conversion price and the number of shares into which a security is potentially convertible

c. Events or changes in circumstances, if any, that could adjust or change the contingency, conversion price, or number of shares, including significant terms of those changes

d. The manner of settlement upon conversion and any alternative settlement methods (for example, cash, shares, or a combination).

50-7 In order to meet the disclosure requirements of the preceding paragraph, the possible conversion prices and dates as well as other significant terms for each convertible instrument shall be disclosed. For example:

The Company is obligated to issue X shares and as the market price of the common stock decreases, the Company is obligated to issue an additional X shares for each $1 decrease in the stock price.

50-8 Additionally, the issuer shall disclose in the notes to financial statements the terms of the transaction, including the excess of the aggregate fair value of the instruments that the holder would receive at conversion over the proceeds received and the period over which the discount is amortized.

50-9 Disclosures shall indicate whether the shares that would be issued if the contingently convertible securities were converted are included in the calculation of diluted earnings per share (EPS) and the reasons why or why not.

50-10 Disclosures of information about derivative instruments entered into in connection with the issuance of the contingently convertible securities may be useful in terms of fully explaining the potential impact of the contingently convertible securities. That information might include the terms of those derivative instruments (including the terms of settlement), how those instruments relate to the contingently convertible securities, and the number of shares underlying the derivative instruments. One example of a transaction entered into in connection with the issuance of a contingently convertible security is the purchase of a call option such that the terms of the purchased call option would be expected to substantially offset changes in value of the written call option embedded in the convertible security. Derivative instruments are also subject to disclosure information, as required by Topic 815.

50-10A For incremental disclosure requirements of debt with conversion and other options, see paragraphs 470-20-10-2 and 470-20-50-3 through 50-6.
For each period for which an income statement is presented, an entity shall disclose all of the following: ...

c. Securities (including those issuable pursuant to contingent stock agreements) that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because to do so would have been antidilutive for the period(s) presented. Full disclosure of the terms and conditions of these securities is required even if a security is not included in diluted EPS in the current period.

Since ASC 470-20 does not contain any specific disclosure requirements related to traditional convertible debt, an issuer considers other disclosure requirements in GAAP. In particular, ASC 505-10 contains disclosure requirements that apply to convertible instruments.

Even though ASC 505-10 is in the equity area of the Codification and its scope provisions do not refer to debt, it is evident from other references in the Codification that some of the disclosure requirements in ASC 505-10-50, particularly those in ASC 505-10-50-3 and ASC 505-10-50-6 through 50-10A, apply to outstanding securities irrespective of whether they are in the form of debt or equity (see, e.g., ASC 470-10-50-5 and ASC 470-20-50-1). Further, before the FASB's codification of U.S. GAAP, those requirements were included in accounting pronouncements that applied to the issuer's disclosure of both debt and equity instruments.

<table>
<thead>
<tr>
<th>Current Guidance</th>
<th>Source</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 505-10-50-3</td>
<td>FASB Statement 129</td>
<td>Requirements related to disclosing information about capital structure, such as an issuer's disclosure of information about securities (including both debt and stock as well as warrants and options).</td>
</tr>
<tr>
<td>ASC 505-10-50-7 and 50-8</td>
<td>EITF Issues 98-5 and 00-27 (legacy BCF literature)</td>
<td>How to apply the requirements for the issuer's disclosure of information about securities under FASB Statement 129 to convertible instruments (both convertible debt and convertible preferred stock) that contain a BCF. For example, ASC 505-10-50-7 contains the EITF's view of how to apply the disclosure requirement in ASC 505-10-50-3 related to “conversion or exercise prices or rates and pertinent dates” to convertible instruments with a BCF. Accordingly, the cross-reference in ASC 505-10-50-7 to “the preceding paragraph” does not limit the scope of application of ASC 505-10-50-7 to contingently convertible securities addressed in ASC 505-10-50-6. Instead, it is relevant for convertible securities more broadly.</td>
</tr>
<tr>
<td>ASC 505-10-50-6, 50-9, and 50-10</td>
<td>FSP FAS 129-1</td>
<td>Disclosures related to contingently convertible securities.</td>
</tr>
</tbody>
</table>

Among the disclosures required by ASC 505-10, the following information is particularly relevant for outstanding convertible securities:

- The pertinent rights and privileges (i.e., the significant terms) of each convertible instrument outstanding, including but not limited to conversion prices or rates and pertinent dates. For example, “[t]he Company is obligated to issue X shares and as the market price of the common stock decreases, the Company is obligated to issue an additional X shares for each $1 decrease in the stock price.”

- The number of shares issued upon conversion, exercise, or satisfaction of required conditions during the most recent annual period and any subsequent interim period presented.
• The period over which any discount is amortized.
• The excess of the aggregate fair value of the instruments that the holder would receive at conversion over the proceeds received.

For contingently convertible securities, an issuer should provide additional disclosures, such as:
• The nature of the contingency and the potential effect of conversion, including:
  o Events or changes in circumstances that would cause the contingency to be met.
  o Any significant features necessary for understanding the conversion rights and the timing of those rights (e.g., the periods in which the contingency might be met and the securities may be converted).
  o The conversion price.
  o The number of shares into which a security is potentially convertible.
  o Events or changes in circumstances that could trigger a change in the contingency, conversion price, or number of shares, including significant terms of those changes.
  o The manner of settlement upon conversion (e.g., cash, shares, or a combination).
  o Alternative settlement methods.
• Whether the shares that would be issued upon a contingent conversion are included in the calculation of diluted EPS and the reasons why or why not.

An issuer should provide special disclosures about derivative instruments that it has executed in connection with the issuance of the contingently convertible securities, such as:
• The terms of those derivative instruments (including the terms of settlement).
• How those instruments are related to the contingently convertible securities.
• The number of shares underlying the derivative instruments.

An issuer should also consider other disclosure requirements that may apply to convertible instruments, such as those related to:
• EPS (in ASC 260-10-50).
• The fair value of financial instruments (in ASC 825-10-50).
• Embedded conversion options that are no longer bifurcated (in ASC 815-15-50-3).

SEC registrants should consider any applicable disclosure requirements issued by the SEC. For example:
• SEC Regulation S-X, Rule 5-02 (reproduced in ASC 210-10-S99-1), requires a registrant to “[s]tate separately, in the balance sheet or in a note thereto, each issue or type of [long-term] obligation and such information as will indicate . . . (1) The general character of each type of debt including the rate of interest; (2) the date of maturity, or, if maturing serially, a brief indication of the serial maturities, such as ‘maturing serially from 1980 to 1990’; (3) if the payment of principal or interest is contingent, an appropriate indication of such contingency; (4) a brief indication of priority; and (5) if convertible, the basis.”
• SEC Regulation S-K, Item 303, requires disclosure within a separate section of the MD&A of information about off-balance-sheet arrangements, including convertible debt arrangements for which the conversion option is not bifurcated as an embedded derivative under ASC 815-15.
The threshold for disclosures about off-balance sheet arrangements in Item 303 is when those arrangements have or are reasonably likely to have a material current or future effect on the registrant’s financial condition, changes in financial condition, revenue and expenses, results of operations, liquidity, capital expenditures, or capital resources. The SEC’s *Current Accounting and Disclosure Issues in the Division of Corporation Finance* (as updated November 30, 2006) notes:

Registrants often disclose a variety of equity-linked contracts, such as convertible debt arrangements, stock warrants and forward agreements to sell shares at pre-set terms, where the registrant has applied the ... scope exception [in ASC 815-10 for contracts on an entity’s own equity], yet the arrangements are not fully disclosed in the off-balance sheet arrangement section of MD&A. To ensure completeness of the information provided in the off-balance sheet arrangement section, registrants should carefully consider whether there are any outstanding contracts indexed to their own stock and classified as stockholders’ equity that are reasonably likely to materially impact the registrant’s financial condition, liquidity or capital resources.
Chapter 5 — Convertible Debt Issued at a Substantial Premium

5.1 Overview

The guidance in U.S. GAAP related to the issuer's accounting for traditional convertible debt (see Chapter 4) contains an exception for convertible debt issued at a substantial premium to par. This chapter discusses the scope of this exception (see Section 5.2 below) as well as the initial and subsequent accounting for instruments within that scope (see Sections 5.3 and 5.4). Because there are no specific incremental derecognition or disclosure requirements for these instruments under GAAP, the related guidance for traditional convertible debt instruments applies (see Sections 4.5 and 4.6).

Changing Lanes

The FASB has tentatively decided to remove the separation model in ASC 470-20 for convertible debt issued at a substantial premium. Instead, an entity would account for a convertible debt instrument wholly as debt (see Chapter 4) unless the instrument contains features that require bifurcation as a derivative under ASC 815 (see Section 2.3 and Appendix A). We expect the FASB to issue a final ASU in the third quarter of 2020. Companies should work with their auditors and accounting advisers to evaluate the potential impact as well as monitor developments and consider the need for disclosure. See Chapter 1 for additional details.

5.2 Scope

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-13 It is not practicable in paragraph 470-20-25-11 to discuss all possible types of debt instruments with conversion features, debt instruments issued with stock purchase warrants, or debt instruments with a combination of such features. Instruments not explicitly discussed in that paragraph shall be dealt with in accordance with the substance of the transaction. For example, if a convertible debt instrument is issued at a substantial premium, there is a presumption that such premium represents paid-in capital.</td>
</tr>
</tbody>
</table>

Sometimes, convertible debt is sold or initially recognized at a substantial premium over the principal amount to be repaid at maturity. In this circumstance, the prohibition in ASC 470-20-25-12 against allocating part of the proceeds to equity does not apply. Instead, there is a presumption that the premium should be recognized in equity as paid-in capital if it is substantial.
Because ASC 470-20-25-13 only applies to convertible debt instruments that are not specifically addressed in other GAAP, the guidance is inapplicable to:

- Convertible debt instruments with a conversion feature that must be bifurcated as a derivative under ASC 815-15 (see Section 2.3 and Appendix A).
- Convertible debt instruments that have a separated equity component under the CCF or BCF guidance in ASC 470-20 (see Chapters 6 and 7).

The guidance on allocating a substantial premium to paid-in capital may apply in circumstances such as the following:

- An acquirer assumes an acquiree's outstanding convertible debt in a business combination.
- Convertible debt is issued upon the exercise of a physically settled liability-classified warrant (see Section 7.3.4).

Although ASC 470-20 does not define substantial, we believe that, in practice, a premium of 10 percent may qualify (e.g., by analogy to ASC 470-50-40-10). In certain circumstances, however, a premium of less than 10 percent may also be considered substantial (e.g., for a zero-coupon convertible debt instrument that is initially recognized at a premium, because of the value of the conversion feature, and for which negative interest expense would be reported if the premium was not allocated to equity).

While ASC 470-20 does not address the circumstances in which an issuer may overcome the presumption that a substantial premium should be recorded in paid-in capital, we believe that the presumption may be overcome if the premium is not attributable to the value of the equity conversion feature. Examples of such circumstances include:

- The convertible debt was issued or assumed at a premium because it pays a higher coupon rate than that on similar nonconvertible debt.
- The convertible debt includes an embedded feature other than the conversion feature that significantly increased the proceeds received for the debt.

### 5.3 Initial Recognition

When initially recognizing convertible debt to which the guidance in ASC 470-20-25-13 on substantial premiums applies, the issuer allocates the initial amount attributable to the debt (see Section 3.5.2) between the instrument's debt and equity components. The face amount is recognized as debt, and the premium is recognized in APIC. The issuer should also determine whether the instrument contains any embedded features that must be bifurcated as derivatives under ASC 815-15-25-1 (e.g., a put, call, redemption, or indexation feature). While the issuer should reduce the initial carrying amount of the convertible debt by any direct or incremental issuance costs paid to third parties associated with the debt's issuance, the guidance in U.S. GAAP does not explicitly address whether or, if so, how to allocate such costs between an instrument's debt and equity components (see Section 3.5.3).

#### Example 5-1

**Convertible Debt Assumed in a Business Combination**

Entity A acquires Entity B and assumes outstanding convertible debt that was previously issued by B. The convertible debt's fair value ($1.2 million) is significantly higher than its principal amount ($1 million). Entity A determines that (1) the conversion option does not have to be bifurcated as a derivative under ASC 815-15 and (2) the debt does not contain a CCF or BCF under ASC 470-20. In accordance with ASC 805-20-30-1, the acquirer in a business combination measures liabilities assumed at their acquisition-date fair values. Because the difference between the convertible debt's fair value and face amount is substantial, A allocates a portion of the initial carrying amount equal to the excess of the fair value over the face amount (i.e., $200,000) to equity (APIC) under ASC 470-20-25-13.
Example 5-2

Convertible Debt Issued Upon Exercise of Liability-Classified Warrant

In EITF Issue 00-27 (superseded), the following tentative guidance illustrated the application of ASC 470-20-25-13 to convertible debt issued upon the exercise of a liability-classified physically settled warrant (see Section 7.3.4.2 for the associated BCF analysis):

Assume Company A issues a freestanding warrant to Company B on January 15, 20X0, for its fair value, $20. The warrant provides Company B with the right during the next 2 years to exercise the warrant for $100 in cash and receive Company A $100 par value convertible debt. The debt is convertible into 10 shares of Company A common stock. The fair value of Company A stock on January 15, 20X0, is $11 per share. Company B exercises the warrant on February 15, 20X1, when the fair value of Company A stock is $20 per share and the fair value and carrying amount of the warrant is $105. The warrant terms require physical settlement upon exercise and Company A has determined that the warrant is classified as a liability. The exercise of the warrant and resulting issuance of the convertible debt would be recorded as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>Warrant Liability</th>
<th>Convertible Debt</th>
<th>Additional Paid-in Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>105</td>
<td>100</td>
<td>105</td>
</tr>
</tbody>
</table>

In this example the accounting resulted in recording the convertible debt at a substantial premium. In this situation, ASC 470-20-25-13 indicates that there is a presumption that the premium represents additional paid-in capital.

5.4 Subsequent Accounting

Since ASC 470-20 does not address the subsequent measurement of convertible debt to which the guidance on substantial premiums in ASC 470-20-25-13 applies, an issuer should refer to other GAAP. Such convertible debt contains a separated equity component (the premium), and thus the issuer cannot elect the fair value option in ASC 825-10 (see Section 2.5). Therefore, except for any bifurcated embedded derivatives, the liability-classified portion of the convertible debt instrument would be subsequently measured at amortized cost, which the issuer determines by using the interest method described in ASC 835-30. The issuer would not subsequently remeasure the amount initially recognized for the premium in equity.
Chapter 6 — Cash Conversion Features

6.1 Overview

6.1.1 General Considerations

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-13</strong> The Cash Conversion Subsections address certain convertible debt instruments that may be settled in cash upon conversion as specified in paragraph 470-20-15-3.</td>
</tr>
</tbody>
</table>

This chapter discusses the guidance in the Cash Conversion subsections of ASC 470-20 on an issuer’s accounting for certain instruments that contain a CCF. The guidance applies not only to debt instruments but also to liability-classified convertible preferred stock (see Section 6.2.2). However, the CCF guidance does not apply if the conversion feature must be bifurcated and accounted for as a derivative instrument under ASC 815-15 (see Sections 2.3 and 6.2.4.1).

Changing Lanes

The FASB has tentatively decided to remove the separation model in ASC 470-20 for convertible debt with a CCF. Instead, an entity would account for a convertible debt instrument wholly as debt (see Chapter 4) unless the instrument contains features that require bifurcation as a derivative under ASC 815 (see Section 2.3 and Appendix A). We expect the FASB to issue a final ASU in the third quarter of 2020. Companies should work with their auditors and accounting advisers to evaluate the potential impact as well as monitor developments and consider the need for disclosure. See Chapter 1 for additional details.

6.1.2 Objective of the CCF Guidance

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>10-1</strong> The objective of the guidance in the Cash Conversion Subsections is that the accounting for a convertible debt instrument within the scope of those Subsections reflect the entity’s nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods.</td>
</tr>
</tbody>
</table>

Economically, a convertible debt instrument can be analyzed as a combination of (1) a debt obligation with a below-market interest coupon and (2) an equity conversion option. Investors are willing to accept a below-market interest rate on their investment because they also receive an equity conversion option. If, for accounting purposes, all the issuance proceeds are attributed to the debt feature, it may appear that the issuer is able to borrow at a below-market rate; however, this ignores the fact that the issuer has given investors a valuable equity conversion option in exchange for the low interest rate. In the absence of a conversion feature, the issuer would have to pay a higher rate that is commensurate with its nonconvertible debt borrowing rate.
Consequently, the objective of the CCF guidance in ASC 470-20 is to ensure that the interest cost of instruments within its scope reflects the issuer’s nonconvertible borrowing rate. That is, as indicated in paragraph B7 of the Background and Basis for Conclusions of FSP APB 14-1, the cost recognized should reflect “the same interest cost [the issuer] would have incurred had it issued a comparable debt instrument without the embedded conversion option.” The issuer accomplishes this by allocating the amounts received as follows:

- **To the liability component** — An amount of proceeds that equals the fair value of a similar liability that does not have an associated equity component.
- **To the equity component** — The remainder of the proceeds.

The resulting debt discount (or reduction in debt premium) increases the reported interest cost in future periods as a result of the application of the effective interest method. Since any debt discounts or premiums are amortized to earnings under this method, the reported interest cost includes the implicit interest cost that was “paid” through the inclusion of a conversion option in the instrument.

The FASB concluded that it would be inappropriate to account for convertible debt instruments that may be settled in cash (including partial settlement) upon conversion wholly as debt in accordance with ASC 470-20-25-12 (see Chapter 4). In paragraph B3 of FSP APB 14-1, the Board observed that such accounting guidance “was based, in part, on [an assumption of] the mutual exclusivity of the debt and the conversion option such that the holder cannot exercise the option to convert into equity shares unless the holder forgoes the right to repayment of the debt component”; however, that assumption is not valid for convertible debt instruments that may be settled in cash upon conversion. Further, such accounting “can provide misleading information to investors,” since “the diluted earnings-per-share treatment of convertible debt instruments with the characteristics of Instrument C [as described in Section 6.1.3 below] is a treasury-stock-type method that is consistent with the diluted earnings-per-share treatment of debt issued with detachable warrants.”

As indicated in paragraph B5 of FSP APB 14-1, the Board considered but decided against expanding the scope of the CCF guidance “broadly to all convertible debt instruments, including those instruments that must be settled entirely in shares upon conversion,” pending “a broad reconsideration of the accounting for all convertible instruments . . . in connection with the Board’s liabilities and equity project.”

The separation and allocation approach required under the CCF guidance differs from approaches that apply to other types of debt instruments with conversion features. In developing the guidance, the FASB concluded that the liability-first separation approach would be less difficult to apply than an equity-first separation approach or a relative-fair value separation approach that potentially would have required an entity to determine the fair value of the conversion feature by using complex option-pricing models. Further, the Board noted that the CCF guidance has a different objective (i.e., to measure the interest cost that is “paid” with the conversion feature) than other separation or allocation approaches under GAAP (e.g., to measure bifurcated embedded derivatives at fair value; see Section 3.5.4).

### 6.1.3 Common Variants

While more traditional forms of convertible debt instruments must be physically settled in the issuer’s equity shares upon conversion, an instrument with a CCF requires or permits settlement of all or part of the instrument’s conversion value by the transfer of cash or other assets. In Issue 90-19, the EITF identified three variants of convertible bonds with CCFs (Instruments A, B, and C); and in his remarks
at the 2003 AICPA Conference on Current SEC Developments, then SEC Professional Accounting Fellow Robert Comerford identified a fourth variant (Instrument X):

<table>
<thead>
<tr>
<th>Settlement Provision</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instrument A</td>
<td>Cash settlement</td>
</tr>
<tr>
<td></td>
<td>“Upon conversion, the issuer must satisfy the obligation entirely in cash based on the fixed number of shares multiplied by the stock price on the date of conversion (the conversion value).”</td>
</tr>
<tr>
<td>Instrument B</td>
<td>Issuer option to elect either cash or physical share settlement</td>
</tr>
<tr>
<td></td>
<td>“Upon conversion, the issuer may satisfy the entire obligation in either stock or cash equivalent to the conversion value.”</td>
</tr>
<tr>
<td>Instrument C</td>
<td>Cash settlement of accreted value and issuer option to elect either net cash or net share settlement of conversion spread</td>
</tr>
<tr>
<td></td>
<td>“Upon conversion, the issuer must satisfy the accreted value of the obligation (the amount accrued to the benefit of the holder exclusive of the conversion spread) in cash and may satisfy the conversion spread (the excess conversion value over the accreted value) in either cash or stock.”</td>
</tr>
<tr>
<td>Instrument X</td>
<td>Combination settlement</td>
</tr>
<tr>
<td></td>
<td>“Instrument X provides the issuer with the ability to settle investor conversions in any combination of shares or cash.”</td>
</tr>
</tbody>
</table>

**Example 6-1**

**Variants of Convertible Debt With CCF**

The following table illustrates how Instruments A, B, C, and X, as described above, would be settled if they each have an accreted value of $1 million and are convertible into 10,000 shares, and the current stock price at the time of conversion is $125:

<table>
<thead>
<tr>
<th>Type</th>
<th>Settlement Upon Conversion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instrument A</td>
<td>The issuer must pay cash of $1,250,000 (10,000 × $125).</td>
</tr>
<tr>
<td>Instrument B</td>
<td>The issuer can elect to either deliver 10,000 equity shares or pay cash of $1,250,000 (10,000 shares × $125).</td>
</tr>
<tr>
<td>Instrument C</td>
<td>The issuer must pay $1,000,000 of cash to settle the accreted value of the debt obligation. To settle the conversion spread, the issuer can elect to either deliver 2,000 equity shares ($250,000 ÷ $125) or pay $250,000 of cash.</td>
</tr>
<tr>
<td>Instrument X</td>
<td>The issuer can elect to deliver any combination of cash and shares whose aggregate value equals $1,250,000 (e.g., 1,000 shares and $1,125,000 of cash).</td>
</tr>
</tbody>
</table>

Note that convertible debt in the form of Instrument A would be exempt from the scope of the CCF guidance in ASC 470-20 because of the requirement to cash settle the conversion feature (see Section 6.2.4.1).
6.2 Scope

6.2.1 Convertible Debt

The Cash Conversion Subsections follow the same Scope and Scope Exceptions as outlined in the General Subsection of this Section, with specific instrument qualifications and exceptions and other considerations noted below.

The guidance in the Cash Conversion Subsections applies only to convertible debt instruments that, by their stated terms, may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative instrument under Subtopic 815-15.

The CCF guidance in ASC 470-20 applies to an issuer’s accounting for a convertible debt instrument that meets the following two conditions: (1) upon conversion, it may be settled either fully or partially in cash or other assets in accordance with its stated terms and (2) the CCF is not required to be separately accounted for as a derivative instrument under ASC 815-15 (see Sections 2.3 and 6.2.4.1). Thus, if convertible debt in the form of Instrument B, C, or X (as described in Section 6.1.3) contains a CCF that is not bifurcated under ASC 815, such instrument is within the scope of the CCF guidance. Similarly, if, upon conversion, a convertible debt instrument permits (1) the counterparty to elect either cash or net share settlement of all or part of the accreted value and (2) the issuer to satisfy the conversion spread in either cash or net shares, such instrument is within the scope of the CCF guidance in ASC 470-20 unless the CCF is bifurcated under ASC 815-15.

6.2.2 Liability-Classified Convertible Preferred Stock

For purposes of determining whether an instrument is within the scope of the Cash Conversion Subsections, a convertible preferred share shall be considered a convertible debt instrument if it has both of the following characteristics:

a. It is a mandatorily redeemable financial instrument.

b. It is classified as a liability under Subtopic 480-10.

For related implementation guidance, see paragraph 470-20-55-70.

An example of a convertible preferred share that paragraph 470-20-15-6 requires an entity [to] consider as a convertible debt instrument for purposes of the scope application of the Cash Conversion Subsections is a convertible preferred share that has a stated redemption date and also would require the issuer to settle the face amount of the instrument in cash upon exercise of the conversion option. Such a convertible preferred share is a mandatorily redeemable financial instrument and is classified as a liability under Subtopic 480-10 because it embodies an unconditional obligation to redeem the instrument by transferring assets at a specified or determinable date (or dates).

ASC 480-10 — Glossary

Mandatorily Redeemable Financial Instrument

Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.
The CCF guidance in ASC 470-20 applies to the issuer’s accounting for convertible preferred stock that meets all of the following four conditions:

1. Upon conversion, it may be settled either fully or partially in cash or other assets in accordance with its stated terms.
2. It meets the definition of a mandatorily redeemable financial instrument in ASC 480-10 (see Section 4.1.1 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity).
3. It is classified as a liability under ASC 480-10 (i.e., it is a mandatorily redeemable financial instrument that is not exempt from the scope of ASC 480-10; see Section 4.1.5 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity).
4. The CCF is not required to be separately accounted for as a derivative instrument under ASC 815-15 (see Section 2.3).

In the application of the CCF guidance in ASC 470-20, such convertible preferred stock is treated as convertible debt.

For a convertible preferred share to meet the definition of a mandatorily redeemable financial instrument and be classified as a liability under ASC 480-10, it must embody an unconditional obligation to transfer assets. A convertible preferred share that the issuer must settle at least partially in cash irrespective of whether it is converted embodies such an obligation, since a transfer of cash or other assets is certain to occur unless there is a violation of the contractual terms. A fixed-term convertible preferred share with conversion terms that are similar to those of Instrument C (as described in Section 6.1.3) typically would meet the definition of a mandatorily redeemable financial instrument and be classified as a liability under ASC 480-10. Accordingly, such an instrument would be within the scope of the CCF guidance in ASC 470-20 unless the CCF must be bifurcated as a derivative instrument under ASC 815-15.

Example 6-2

Convertible Preferred Stock Subject to CCF Guidance

A convertible preferred share has (1) a fixed redemption date on which the issuer will settle its stated par amount in cash and (2) a substantive conversion option that, if exercised by the counterparty, requires the issuer to settle the par amount in cash but permits it to settle the excess of the conversion value over the par amount (the conversion spread) in either cash or shares. The convertible preferred share meets the definition of a mandatorily redeemable financial instrument and is classified as a liability under ASC 480-10 since the issuer has an unconditional obligation to transfer cash or other assets in exchange for the par amount. Because the issuer has the option to settle the conversion spread in either cash or shares upon conversion, the instrument is within the scope of the CCF guidance in ASC 470-20 unless the issuer concludes that the conversion feature must be bifurcated as an embedded derivative under ASC 815-15 (see Section 2.3).

A convertible preferred share that has a stated redemption date and permits the issuer to elect settlement of the entire instrument in either cash or shares (in a manner similar to Instrument B as described in Section 6.1.3) or any combination of cash or shares (in a manner similar to Instrument X as described in Section 6.1.3) does not contain an unconditional obligation to transfer assets because the issuer has the right to settle the entire conversion value in shares. Accordingly, preferred stock with terms similar to those of Instrument B or X is not within the scope of the CCF guidance in ASC 470-20.

A requirement to transfer assets that is contingent on the counterparty’s election of a cash settlement or the occurrence (or nonoccurrence) of an uncertain future event represents a conditional, rather than an unconditional, obligation to transfer assets. Thus, convertible preferred stock that has such a requirement is not within the scope of the CCF guidance in ASC 470-20. For example, a perpetual...
convertible preferred share that must be settled in cash or other assets upon the counterparty’s election to convert does not meet the definition of a mandatorily redeemable financial instrument in ASC 480-10 because the obligation to transfer cash or other assets is contingent on such election.

**Connecting the Dots**

For further discussion of determining whether a share meets the definition of a mandatorily redeemable financial instrument and would be classified as a liability under ASC 480-10, see Chapter 4 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*.

### 6.2.3 Exceptions

#### 6.2.3.1 Equity-Classified Convertible Stock

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-5 The Cash Conversion Subsections do not apply to any of the following instruments:</td>
</tr>
<tr>
<td>a. A convertible preferred share that is classified in equity or temporary equity. . . .</td>
</tr>
</tbody>
</table>

The CCF guidance in ASC 470-20 does not apply to convertible instruments that are classified in equity or temporary equity. For instance, such guidance does not apply to an equity-classified preferred share that contains an option for the holder to convert it into a different class of equity shares even if the conversion terms require or permit the issuer to pay cash to settle the conversion value. See Chapter 9 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity* for additional guidance on preferred stock that is classified in temporary equity.

#### 6.2.3.2 Holders of Underlying Shares Receive Same Form of Consideration

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-5 The Cash Conversion Subsections do not apply to any of the following instruments: . . .</td>
</tr>
<tr>
<td>b. A convertible debt instrument that requires or permits settlement in cash (or other assets) upon conversion only in specific circumstances in which the holders of the underlying shares also would receive the same form of consideration in exchange for their shares. . . .</td>
</tr>
</tbody>
</table>

The CCF guidance in ASC 470-20 does not apply if the convertible debt instrument only requires or permits settlement in cash or other assets upon conversion if the holders of the shares underlying the convertible instrument receive, or have a right to receive, the same form of consideration for their shares. However, this scope exception is not available if, upon conversion, the form of consideration (e.g., cash, shares, property, or other assets) would be different from the form of consideration paid to holders of the underlying shares.

#### 6.2.3.3 Cash Settlement of Fractional Shares

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-5 The Cash Conversion Subsections do not apply to any of the following instruments: . . .</td>
</tr>
<tr>
<td>c. A convertible debt instrument that requires an issuer’s obligation to provide consideration for a fractional share upon conversion to be settled in cash but that does not otherwise require or permit settlement in cash (or other assets) upon conversion.</td>
</tr>
</tbody>
</table>
A fractional share of stock is a quantity of shares that is less than one full share. The CCF guidance in ASC 470-20 does not apply to a convertible debt instrument merely because it requires or permits the issuer to cash settle any obligation to deliver fractional shares.

Example 6-3

**Convertible Debt Instrument With Fractional Shares Settled in Cash**

Issuer A has an obligation to deliver 15.333 shares upon conversion of a convertible debt instrument. The terms of the instrument require A to settle the obligation in shares except for any fractional shares, which are settled in a cash amount that equals their current market value. Upon conversion, therefore, A delivers 15 shares and a cash amount that equals the current market value of 0.333 shares. Even though A has an obligation to deliver cash upon conversion, the CCF guidance in ASC 470-20 does not apply because the obligation to deliver cash applies only to fractional shares.

6.2.4 Other Considerations

6.2.4.1 Embedded Derivatives

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-4</strong> The guidance in this Section shall be considered after consideration of the guidance in Subtopic 815-15 on bifurcation of embedded derivatives, as applicable (see paragraph 815-15-55-76A). . . . The guidance in the Cash Conversion Subsections does not affect an issuer’s determination under Subtopic 815-15 of whether an embedded feature shall be separately accounted for as a derivative instrument.</td>
</tr>
<tr>
<td><strong>25-25</strong> If a convertible debt instrument within the scope of the Cash Conversion Subsections contains embedded features other than the embedded conversion option (for example, an embedded prepayment option), the guidance in Subtopic 815-15 shall be applied to determine if any of those features must be separately accounted for as a derivative instrument. As discussed in paragraph 470-20-15-4, the guidance in the Cash Conversion Subsections does not apply if there is no equity component because the embedded conversion option is being separately accounted for as a derivative under Subtopic 815-15.</td>
</tr>
</tbody>
</table>

The requirements in ASC 470-20 (e.g., the CCF guidance) do not apply if the conversion feature must be bifurcated and accounted for as a derivative instrument under ASC 815. Therefore, an issuer needs to determine whether ASC 815-15 requires bifurcation of the CCF before it can conclude whether the CCF guidance in ASC 470-20 applies to the instrument. However, if a feature other than the conversion feature (e.g., a call or put option) must be bifurcated from the convertible debt instrument, the instrument is not exempt from the CCF guidance in ASC 470-20 (see Section 6.3.6).

Because of this scope exception, the CCF guidance in ASC 470-20 does not apply to convertible debt instruments in the form of Instrument A (as described in Section 6.1.3). Since the issuer must settle the conversion feature of such instruments in cash, they meet the net settlement characteristic in the definition of derivative instruments in ASC 815-10-15-83 and do not qualify for the scope exception in ASC 815-10-15-74(a) for certain contracts on the entity’s own equity. Further, an equity feature is not clearly and closely related to a debt host. Therefore, unless the issuer elects to account for convertible debt in the form of Instrument A at fair value, with changes in fair value recognized in earnings under the fair value option in ASC 825-10 (see Section 2.5), the conversion feature in such an instrument is separated as an embedded derivative under ASC 815-15. Irrespective of whether the issuer bifurcates the conversion feature under ASC 815-15 or elects to apply the fair value option to the entire instrument under ASC 825-10, convertible debt in the form of Instrument A is exempt from the scope of ASC 470-20. For similar reasons, the CCF guidance in ASC 470-20 generally does not apply to a convertible debt instrument if the holder has an option to require the issuer to settle either the full conversion value or the conversion spread in cash.
A convertible debt instrument within the scope of the CCF guidance in ASC 470-20 could qualify as conventional convertible debt under ASC 815-40-25-39 if, in a manner similar to Instrument B, the holder is able to realize the value of the conversion option only by exercising it and receiving the entire proceeds in a fixed number of shares or an equivalent amount of cash at the issuer’s discretion. In such a case, some of the equity classification conditions in ASC 815-40-25 would not apply.

**Connecting the Dots**

For a discussion of the evaluation of whether an equity conversion feature qualifies as equity under ASC 815-40, see Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*. Section 5.5 of that Roadmap addresses the requirements related to conventional convertible debt.

### 6.2.4.2 Share-Settled Redemption or Indexation Features

As discussed in Section 2.4, a contractual term that economically represents a share-settled put, call, redemption, or indexation provision should not be analyzed as a conversion feature under ASC 470-20 even if the instrument’s terms describe it as a “conversion feature.”

**Example 6-4**

**Share-Settled Debt**

The terms of a debt instrument include an option that permits the holder to “convert” the instrument on a specified date. Upon conversion, the issuer is required to settle the principal amount and any accrued and unpaid interest either in cash or a variable number of equity shares of equal value. The conversion price is defined as (1) the sum of $1 million plus unpaid and accrued interest divided by (2) the market price of the common stock on the conversion date. Although the contract refers to the option as a conversion feature and the issuer has the right to settle the feature either in cash or equity shares, the instrument should not be analyzed as a debt instrument with a CCF under ASC 470-20 because the monetary amount of the obligation is unrelated to the fair value of the issuer’s equity shares.

### 6.2.4.3 Fair Value Option

**ASC 470-20**

| 25-21 Paragraph 825-10-15-5(f) states that no entity may elect the fair value option for financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder’s equity (including temporary equity) (for example, a convertible debt instrument within the scope of the Cash Conversion Subsections or a convertible debt security with a noncontingent beneficial conversion feature). |

Because ASC 470-20 requires the issuer of a convertible debt instrument that is within the scope of the CCF guidance to separate it into liability and equity components at issuance, the issuer is not permitted to elect the fair value option in ASC 825-10 for such an instrument. By analogy, the instrument is also not eligible for the fair value option in ASC 815-15 (see Section 2.5 for further discussion).

### 6.2.4.4 The SEC’s Requirements Related to Temporary Equity

As discussed in Section 2.6, an issuer that is an SEC registrant should consider whether the SEC’s guidance on redeemable securities in ASC 480-10-S99-3A applies to convertible debt instruments that are separated into liability and equity components under the CCF guidance in ASC 470-20. While the SEC’s guidance on temporary equity applies to equity-classified redeemable stock even if it is not currently redeemable, such guidance does not apply to convertible debt with a CCF that is not currently redeemable even if it may become redeemable in the future. As indicated in ASC 480-10-S99-3A(12), for convertible debt with a CCF, the amount of temporary equity is limited to the excess (if any) of “(1) the
amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion . . . over (2) the carrying amount of the liability-classified component of the convertible debt instrument” both at initial measurement and on subsequent balance sheet dates.

**Connecting the Dots**

For further discussion of the application of the SEC’s guidance on temporary equity, see Sections 9.3.5, 9.4.8, 9.5.7, and 9.6.4 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*.

### Example 6-5

**Application of ASC 480-10-S99-3A to Puttable Convertible Debt With a CCF**

A convertible debt instrument subject to the CCF guidance in ASC 470-20 was issued for net proceeds of $100 and includes a cash-settled put option that permits the investor to put the instrument back to the issuer at any time for $97. As of the issuance date, the issuer concluded that the put option was (1) nonsubstantive (i.e., its exercise was not probable; see Section 6.3.2.2) and (2) not required to be bifurcated and accounted for as a derivative under ASC 815-15. As of the reporting date, the current carrying amount of the liability component is $90 and the current carrying amount of the equity component is $10. In this case, the issuer would present $3 of the equity component in permanent equity and $7 in temporary equity because $7 of the equity component is currently redeemable (i.e., the excess of the current redemption amount over the carrying amount of the debt’s liability component).

If, instead, the put option was contingent and the contingency was not met as of the reporting date, no amount would be presented in temporary equity (irrespective of whether it was probable that the contingency would be met in the future) because the SEC’s guidance on redeemable securities in ASC 480-10-S99-3A only applies to convertible debt instruments with a separately classified equity component if the instrument is currently redeemable or convertible as of the reporting date.

### 6.2.4.5 Beneficial Conversion Features

The General subsections of ASC 470-20 include requirements for the separate presentation in equity of BCFs in certain convertible debt instruments (see Chapter 7). As noted in ASC 470-20-15-2, that guidance does not apply to an equity conversion feature that causes the convertible debt instrument in which it is embedded to be separated into liability and equity components under the CCF guidance in ASC 470-20. Accordingly, an issuer should evaluate whether the CCF guidance applies before potentially considering the BCF guidance. If the CCF guidance in ASC 470-20 applies, the issuer should not analyze the conversion feature under the BCF guidance.

### 6.3 Initial Accounting

**6.3.1 Separation of Liability and Equity Components**

**ASC 470-20**

25-22 The liability and equity components of a convertible debt instrument within the scope of the Cash Conversion Subsections shall be accounted for separately. Recognition of a convertible debt instrument within the scope of the Cash Conversion Subsections is not addressed by paragraph 470-20-25-12.

25-23 The issuer of a convertible debt instrument within the scope of the Cash Conversion Subsections shall do both of the following:

a. First, determine the carrying amount of the liability component in accordance with the guidance in paragraph 470-20-30-27.

b. Second, determine the carrying amount of the equity component represented by the embedded conversion option in accordance with the guidance in paragraph 470-20-30-28.
Chapter 6 — Cash Conversion Features

The issuer of a convertible debt instrument within the scope of the CCF guidance in ASC 470-20 is required to (1) separate the instrument into liability and equity components and (2) allocate the issuance proceeds and transaction costs that are attributable to the instrument between the two components. In a manner consistent with the illustrative example in ASC 470-20-55-75, the equity component is presented within equity as APIC.

To measure the components, the issuer uses a “liability-first” allocation approach as follows:

1. Determine the carrying amount of the liability component (before the allocation of any transaction costs) on the basis of the fair value of a hypothetical nonconvertible debt instrument (see Section 6.3.2 below).

2. Determine the carrying amount of the equity component (before allocation of any transaction costs) by using a residual approach — that is, allocate to the equity component the amount of the instrument’s issuance proceeds that remain after allocation to the liability component (see Section 6.3.3).

3. Allocate qualifying transaction costs between the liability and equity components in proportion to the allocation of proceeds between each component in steps 1 and 2 (see Section 6.3.4).

If an outstanding convertible debt instrument that is not within the scope of the CCF guidance is modified so that it becomes subject to it, the CCF guidance is applied prospectively (see Section 6.5.3.4). If an outstanding debt instrument with a CCF was not within the scope of the CCF guidance because the conversion feature was required to be bifurcated as a derivative instrument under ASC 815-15 and the instrument subsequently becomes subject to the CCF guidance because the conversion feature no longer requires bifurcation under ASC 815-15, the issuer should reclassify the current carrying amount (fair value) of the conversion feature to equity and continue to amortize any debt discount (see ASC 470-20-35-20 and ASC 815-15-35-4 as well as Section 6.4 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity).

6.3.2 Initial Measurement of the Liability Component

6.3.2.1 Hypothetical Nonconvertible Debt

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-27 The carrying amount of the liability component shall be determined for purposes of paragraph 470-20-25-23 by measuring the fair value of a similar liability (including any embedded features other than the conversion option) that does not have an associated equity component.</td>
</tr>
</tbody>
</table>

When allocating issuance proceeds between the liability and equity components of convertible debt under the CCF guidance in ASC 470-20, the issuer measures the initial carrying amount of the liability component as the fair value of a hypothetical nonconvertible debt instrument — that is, a comparable liability without an equity component, adjusted for any transaction costs that are allocable to the liability component (see Section 6.3.4). Such a hypothetical nonconvertible debt instrument has terms and features that exactly match those of the actual convertible debt instrument issued except for (1) the conversion feature (i.e., the equity component) and (2) any features that are nonsubstantive at issuance. For instance, the hypothetical nonconvertible debt has the same coupon rate as the convertible debt instrument. Other than the equity conversion feature, the terms of the hypothetical nonconvertible debt include all substantive terms and features of the actual convertible debt (such as any substantive embedded put or call options) embedded in the instrument irrespective of whether they must be bifurcated under ASC 815-15.
The terms of some convertible debt instruments contain exercise contingencies, such as provisions that permit the conversion feature to be exercised if (1) the underlying stock trades above a specified price (e.g., 130 percent of par), (2) the convertible debt trades for an amount below its if-converted value (e.g., 98 percent of its if-converted value), or (3) a fundamental change (e.g., a change of control) occurs. An exercise contingency that solely affects the exercisability of the conversion option should be analyzed as part of the equity conversion feature. Therefore, such a feature would not be part of the terms of the hypothetical nonconvertible debt instrument that is used to measure the liability component’s fair value.

6.3.2.2 Nonsubstantive Features

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-29 An embedded feature that is determined to be nonsubstantive at the issuance date shall not affect the initial measurement of the liability component.</td>
</tr>
</tbody>
</table>

**Determining Whether an Embedded Feature Is Nonsubstantive**

| 30-30 Solely for purposes of applying the initial measurement guidance in paragraphs 470-20-30-27 through 30-28 and the subsequent measurement guidance in paragraph 470-20-35-15, an embedded feature other than the conversion option (including an embedded prepayment option) shall be considered nonsubstantive if, at issuance, the entity concludes that it is probable that the embedded feature will not be exercised. That evaluation shall be performed in the context of the convertible debt instrument in its entirety. |

The terms of the hypothetical nonconvertible debt used to measure the liability component’s fair value exclude any feature of the actual convertible debt instrument (e.g., an embedded prepayment, call, or put option) that is considered nonsubstantive as of the issuance date. The determination of whether a feature is nonsubstantive is based on an evaluation as of the issuance date of the likelihood that the feature will not be exercised. To make this assessment, the entity considers all the terms of the actual convertible debt instrument, including the embedded conversion feature, rather than the terms of the hypothetical nonconvertible debt. A feature is nonsubstantive if it is probable, at issuance, that it will not be exercised.

**Example 6-6**

**Put Feature**

A convertible debt security has a maturity date that is 20 years from the issuance date and an embedded put feature that is exercisable at par three months after the issuance date. The issuer concludes that, as of the issuance date, it is probable that the put feature will not be exercised. Accordingly, the terms of the hypothetical nonconvertible debt do not incorporate the put feature and it is ignored in the fair value measurement of the liability component.

The guidance on nonsubstantive features in ASC 470-20 does not exempt such features from the requirement in ASC 815-15 to evaluate whether they must be bifurcated as embedded derivatives (see Section 2.3). Thus, an embedded feature in a convertible debt instrument subject to the CCF guidance in ASC 470-20 may have to be bifurcated as an embedded derivative under ASC 815-15 even if it is considered nonsubstantive under ASC 470-20. Further, the issuer would separate the embedded feature from the liability component of the convertible debt even though it would determine the fair value of that component without taking into account the feature under ASC 470-20.

A provision of a convertible debt instrument within the scope of the CCF guidance in ASC 470-20 might allow the holder to require the issuer’s repayment of the debt if a change in control occurs. If it is determined that a change-in-control provision is substantive, the entity should consider the provision
in its initial measurement of the liability component's fair value and its assessment of the hypothetical nonconvertible debt's expected life for use in the amortization of any debt discount and issuance costs. A change-in-control provision would be considered nonsubstantive if, as of the issuance date, it was probable that a change-in-control event would not occur or, for other reasons, it was probable that the feature would not be exercised. In determining whether the change-in-control provision is nonsubstantive, an entity should assess the convertible debt instrument in its entirety and consider all relevant terms and provisions (i.e., including the conversion option). The original determination of whether the change-in-control event is likely to occur should not be reassessed unless the terms of the debt agreement are modified.

### 6.3.2.3 Fair Value Measurement

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-73 . . . Depending on the terms of the instrument (for example, if the instrument contains prepayment features other than the embedded conversion option) and the availability of inputs to valuation techniques, it may be appropriate to determine the fair value of the liability component using an expected present value technique (an income approach), a valuation technique based on prices and other relevant information generated by market transactions involving comparable liabilities (a market approach) or both an income approach and a market approach.</td>
</tr>
</tbody>
</table>

In measuring the fair value of the liability component on the basis of the terms of hypothetical nonconvertible debt, an entity applies the fair value measurement guidance in ASC 820-10. Under that guidance, the measurement objective is “to estimate the price at which an orderly transaction to . . . transfer the liability would take place between market participants at the measurement date under current market conditions.” As stated in ASC 820-10-35-16AA, to meet this objective, the issuer should “maximize the use of relevant observable inputs and minimize the use of unobservable inputs.” Depending on the terms of the hypothetical nonconvertible debt and the availability of inputs, either an income approach (e.g., the present value of the cash flows of the nonconvertible debt over its expected life discounted by using the issuer’s nonconvertible debt borrowing rate) or a market approach (e.g., using quoted prices for similar nonconvertible debt held by other parties as assets) or both may be appropriate.

### 6.3.2.4 Application of an Income Approach

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-15 Embedded features that are determined to be nonsubstantive at the issuance date shall not affect the expected life of the liability component. Paragraph 470-20-30-30 provides guidance on assessing whether an embedded feature other than the conversion option (including an embedded prepayment option) shall be considered nonsubstantive at issuance for purposes of this paragraph.</td>
</tr>
</tbody>
</table>

If the issuer initially measures the fair value of the hypothetical nonconvertible debt by using an income approach, its estimate of fair value reflects the contractual cash flows through the expected life of the hypothetical nonconvertible debt discounted by using the issuer’s nonconvertible debt borrowing rate.

#### 6.3.2.4.1 Estimating Expected Life

Because the initial and subsequent measurements of the liability component are based on the fair value of a similar liability that does not have an associated equity component (ASC 470-20-30-27 and ASC 470-20-35-13), an entity disregards the conversion option and any other nonsubstantive embedded features in estimating the liability component’s expected life. This is the case even though the conversion
option may affect the likelihood that other substantive features would be exercised or triggered. For example, an investor may be less likely to exercise a put option embedded in a debt instrument if its exercise would cause a loss of any intrinsic or time value associated with a conversion option embedded in the same instrument. Nevertheless, when estimating the expected life of the liability component, the issuer should assume that no conversion option exists.

The terms of some conversion options contain exercise contingencies (e.g., holders can only exercise an option if the last reported sales price of the issuer’s common stock is greater than or equal to 130 percent of the conversion price). If an exercise contingency solely affects the exercisability of the conversion option, the contingency should be considered part of the conversion option in the estimation of the hypothetical nonconvertible debt’s expected life. Accordingly, an issuer would not consider such an exercise contingency when determining the expected life of the convertible debt instrument’s liability component.

If there is a substantive put feature that holders can exercise at par before the debt’s maturity date, the expected life of the hypothetical nonconvertible debt is usually shorter than its contractual term. Such hypothetical debt has the same coupon rate as the convertible debt instrument, which typically is lower than current market rates for similar nonconvertible debt. Provided that (1) interest rates are not expected to decrease significantly and (2) no other embedded features (other than the conversion feature) are sufficiently valuable to induce the investor to continue holding the hypothetical nonconvertible debt instrument, the investor would be expected to exercise the put option at its first available opportunity because the coupon rate is below market rates. Accordingly, if hypothetical nonconvertible debt contains a substantive put feature whose exercise amount is equal to or in excess of par, the debt’s expected life usually extends only until the earliest date on which the investor can put the debt to the issuer. (This observation might not be valid, however, if the exercise amount of the put feature is less than the principal amount of the debt.) Conversely, the existence of a call or prepayment feature payable at par typically does not affect such debt’s expected life; unless there was a significant decrease in interest rates, the issuer would not call a debt instrument that was issued at a coupon rate below market rates.

If a convertible debt instrument contains substantive noncontingent mirror-image put and call options that are exercisable on the same date and at the same price, it is highly likely that either the put or call option would be exercised on that date provided that the instrument had not been previously converted. If the fair value of the liability component is below the exercise price, the holder may be likely to put the hypothetical nonconvertible debt; and if the fair value of the liability component exceeds the exercise price, the issuer may be likely to call the hypothetical nonconvertible debt. In this case, the expected life does not extend beyond the exercise date of the put and call options.

The existence of nonsubstantive features (see Section 6.3.2.2) does not affect the issuer’s estimate of the expected life. For example, a put option that is only exercisable upon a fundamental change would not affect the expected life of the liability component if the issuer, as of the issuance date, concludes that it is probable that such a fundamental change will not occur. An embedded feature is nonsubstantive if, at issuance, it is probable that it will not be exercised (see ASC 470-20-30-30).

6.3.2.4.2 Estimating Nonconvertible Debt Borrowing Rate

The nonconvertible debt borrowing rate is the interest rate the issuer would have to pay on the hypothetical nonconvertible debt. Typically, entities do not have outstanding publicly traded or recently issued nonconvertible debt with terms that are identical to those of the hypothetical instrument. Therefore, they might need to determine the market interest rate that currently could reasonably be expected for such an instrument. Two common approaches are to calculate the hypothetical
nonconvertible debt’s interest rate on the basis of (1) similar outstanding debt issued by the entity or
(2) similar debt issued by other similar entities.

If the entity determines that it is appropriate to consider the current market rates on its outstanding
debt (e.g., term loans or lines of credit) to calculate the interest rate of the hypothetical nonconvertible
debt instrument, it should consider (1) any differences between such debt and the hypothetical
nonconvertible debt (e.g., call or put options, or the level of seniority) and (2) market changes (e.g.,
interest rate changes or changes in the entities’ credit ratings) after the issuance of such debt. If any
differences exist, the entity must appropriately adjust the debt’s interest rate.

Alternatively, an entity may estimate the borrowing rate of the hypothetical debt by referring to the
current market interest rates for similar debt issued by other similar entities. To be considered similar,
those other entities must have, for example, comparable credit ratings and access to the market in
which the entity’s own debt was issued. The entity should also consider differences in the other entities’
credit spreads and general access to debt that arise from being in different industry sectors. If any
differences exist, the entity must appropriately adjust the other entities’ borrowing rate to determine the
market interest rate for the hypothetical nonconvertible debt instrument.

If an entity purchases a call option on its own equity concurrently with issuing convertible debt that
is within the scope of the CCF guidance, the option’s fair value may provide relevant information for
determining the nonconvertible debt borrowing rate that is used under an income approach to estimate
the liability component’s fair value. Paragraph B9 of FSP APB 14-1 states, in part:

[C]onvertible debt instruments issued in the United States often contain contingent interest provisions that
enable the issuer to receive an income tax deduction based on its nonconvertible debt borrowing rate. Some
entities purchase call options on their own stock concurrently with the issuance of convertible debt, and the
two instruments are integrated for tax purposes, resulting in a tax deduction that may be similar to their
nonconvertible debt borrowing rate. Consequently, many issuers of convertible debt instruments within the
scope of [the CCF guidance] are obtaining some of the information that may be used to estimate the fair value
of the liability component in order to adequately support deductions taken on their U.S. federal income tax
returns.

6.3.3 Initial Measurement of the Equity Component

In the allocation of proceeds between the liability and equity components of a convertible instrument
within the scope of the CCF guidance in ASC 470-20, the equity component is not measured directly but
instead represents a residual amount that is determined by deducting (1) the amount allocated to the
liability component from (2) the initial proceeds attributable to the convertible debt (see Section 6.3.5).
As noted in paragraph B8 of FSP APB 14-1 (which quotes paragraph BC30 of IAS 32), this approach
“removes the need to estimate inputs to, and apply, complex option pricing models to measure the
equity component.” Further, an adjustment is made to the initial carrying amount for any transaction
costs allocable to the equity component (see Section 6.3.4).

If an issuer of convertible debt purchases a call option on its own equity concurrently with the issuance
of the convertible debt, the issuer cannot assume that the initial measurement of the equity component
under the CCF guidance in ASC 470-20 would equal the fair value of the purchased call option. For
instance, the fair value of the purchased option may differ from the amount of the proceeds allocable to
the equity component because of (1) market pricing inefficiencies, (2) differences in the creditworthiness of the counterparties to the debt and the purchased call option, or (3) differences in terms or other features included in the debt and the purchased call option. Notwithstanding these differences, the call option’s fair value may be an input into the determination of the liability component’s fair value (see Section 6.3.2.4.2).

6.3.4 Transaction Costs

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-26 Transaction costs incurred with third parties other than the investor(s) and that directly relate to the issuance of convertible debt instruments within the scope of the Cash Conversion Subsections shall be allocated to the liability and equity components in accordance with the guidance in paragraph 470-20-30-31.</td>
</tr>
<tr>
<td>30-31 Transaction costs required to be allocated to the liability and equity components by paragraph 470-20-25-26 shall be allocated in proportion to the allocation of proceeds and accounted for as debt issuance costs and equity issuance costs, respectively.</td>
</tr>
</tbody>
</table>

Third-party costs that are directly related to the issuance of a convertible instrument within the scope of the CCF guidance are allocated to the liability and equity components in the same proportion as the proceeds allocation. Such transaction costs are limited to specific incremental costs that are directly attributable to issuing the convertible debt (see Section 3.5.3.1).

Accordingly, an issuer determines the amount of proceeds that should be allocated to the liability and equity components before allocating any transaction costs. For instance, if 80 percent of the issuance proceeds are allocated to the liability component and the remaining 20 percent to the equity component, 80 percent of the transaction costs would be allocated to the liability component and 20 percent to the equity component.

Transaction costs allocated to the liability component are accounted for as debt issuance costs in accordance with ASC 835-30. Under ASC 835-30-45-1A, such costs are reported on the balance sheet as a direct deduction from the carrying amount of the liability component rather than as a deferred charge upon issuance of the debt.

Transaction costs allocated to the equity component are recognized in APIC as equity issuance costs. Such costs are charged against the proceeds allocated to the equity component; that is, transaction costs allocated to the equity component are deducted from the amount of proceeds allocated to the equity component, and the net amount is recorded in equity.

6.3.5 Multiple-Element Transactions

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-24 If the issuance transaction for a convertible debt instrument within the scope of the Cash Conversion Subsections includes other unstated (or stated) rights or privileges in addition to the convertible debt instrument, a portion of the initial proceeds shall be attributed to those rights and privileges based on the guidance in other applicable U.S. generally accepted accounting principles (GAAP).</td>
</tr>
</tbody>
</table>

Sometimes, a convertible debt instrument is issued in a transaction that includes elements not attributable to the debt (e.g., other freestanding financial instruments; see Section 3.4). If the issuance of a convertible instrument within the scope of the CCF guidance in ASC 470-20 includes other rights or privileges, the issuer is required to allocate part of the initial proceeds related to those rights and
privileges in a manner consistent with the guidance in ASC 835-30-25-6 before allocating proceeds and transaction costs to the liability and equity components. In these circumstances, the entity might also need to allocate a portion of the transaction costs to the other instruments or rights and privileges that are separately recognized.

### 6.3.6 Embedded Derivatives

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-76A</strong></td>
</tr>
</tbody>
</table>

a. Step 1. Identify embedded features other than the embedded conversion option that must be evaluated under Subtopic 815-15.

b. Step 2. Apply the guidance in Subtopic 815-15 to determine whether any of the embedded features identified in Step 1 must be separately accounted for as derivative instruments. Paragraph 470-20-15-4 states that the guidance for a convertible debt instrument within the scope of the Cash Conversion Subsections of Subtopic 470-20 does not affect an issuer's determination of whether an embedded feature shall be separately accounted for as a derivative instrument.

c. Step 3. Apply the guidance in paragraph 470-20-25-23 to separate the liability component (including any embedded features other than the conversion option) from the equity component.

d. Step 4. If one or more embedded features are required to be separately accounted for as a derivative instrument based on the analysis performed in Step 2, that embedded derivative shall be separated from the liability component in accordance with the guidance in this Subtopic. Separation of an embedded derivative from the liability component would not affect the accounting for the equity component.

If any feature other than the conversion feature is required to be bifurcated as an embedded derivative (e.g., an embedded put or call option), it is treated as part of the liability component in the separation of the liability and equity components under the CCF guidance in ASC 470-20. After separation of the liability component, the embedded derivative is bifurcated from the liability component at its fair value and has no effect on the accounting for the equity component. The portion of the amount attributable to the liability component that remains after bifurcation of the embedded derivative is allocated to the host liability component.

As indicated in ASC 470-20-15-4, the CCF guidance in ASC 470-20 does not affect the determination of whether an embedded feature should be separated and accounted for as a derivative instrument. Therefore, when evaluating whether any embedded feature other than the conversion option must be bifurcated from the convertible instrument, the issuer should not consider the separation of the equity component as having created a discount to the liability component under the CCF guidance in ASC 470-20. A discount could, however, be created from the allocation of proceeds to other separately recognized freestanding financial instruments issued in conjunction with a convertible debt instrument. For example, a discount created by the separation of an equity component under ASC 470-20 would not be treated as a discount in the evaluation of whether debt with an embedded put or call feature involves a substantial premium or discount under ASC 815-15-25-40 and ASC 815-15-25-42. Further, an entity would evaluate whether an embedded feature must be bifurcated under ASC 815-15 even if it is considered nonsubstantive under the CCF guidance in ASC 470-20.
6.3.7 Deferred Taxes

**ASC 470-20**

25-27 Recognizing convertible debt instruments within the scope of the Cash Conversion Subsections as two separate components — a debt component and an equity component — may result in a basis difference associated with the liability component that represents a temporary difference for purposes of applying Subtopic 740-10. The initial recognition of deferred taxes for the tax effect of that temporary difference shall be recorded as an adjustment to additional paid-in capital.

Depending on the applicable taxation requirements, the separation of an equity component under ASC 470-20 often causes the carrying amount of the liability component under GAAP (the book basis) to be different from the tax basis of the debt determined in accordance with ASC 740-10. In practice, such basis differences usually result in the recognition of a deferred tax liability under ASC 740-10 upon the issuance of an instrument within the scope of the CCF guidance in ASC 470-20 because the tax basis exceeds the book basis after the separation of an equity component under ASC 470-20.

Paragraph B13 of FSP APB 14-1 states, in part:

In some jurisdictions, the tax basis of a convertible debt instrument at initial recognition includes the entire amount of the proceeds received at issuance. As a result, a taxable temporary difference arises from the initial recognition of the equity component separately from the liability component. The Board decided that the initial recognition of deferred taxes for the tax effect of the temporary difference should be recorded as an adjustment to additional paid-in capital. That treatment is consistent with the guidance on convertible debt with a beneficial conversion feature in ASC 740-10-55-51.

**Example 6-7**

**Deferred Taxes on Debt With a CCF**

A convertible debt instrument within the scope of the CCF guidance was issued for proceeds of $100. The tax basis of the debt under the applicable taxation requirements is the original issue price adjusted for any original issue discount or premium before any separation of an equity component for accounting purposes (i.e., the tax basis is $100). However, because of the application of the CCF guidance in ASC 470-20, the debt's book basis (i.e., the carrying amount of the liability component) is $80 after separation of an equity component. If the issuer's tax rate is 21 percent, it will recognize a deferred tax liability under ASC 740-10 of $4 ($100 – $80) × 21%.

Because the separation of the equity component from the debt creates the basis difference in the debt, the establishment of a deferred tax liability for the basis difference results in a charge to the related components of shareholders' equity (see ASC 740-20-45-11(c)). Thus, ASC 470-20-25-27 requires entities to record the recognition of deferred taxes as an adjustment to APIC, and the initial accounting entries are as follows:

| Cash       | 100 |
| APIC      | 4   |
| Debt      | 80  |
| APIC      | 20  |
| Deferred tax liability | 4 |

For financial reporting purposes, interest expense in subsequent periods includes a noncash component that reflects the amortization of the debt discount created by the separation of the equity component. This noncash component of reported interest expense is not deductible for U.S. income tax purposes. As interest expense is recognized for the liability component after initial recognition, the deferred tax liability is reduced and a deferred tax benefit is recognized in earnings through the amortization of the debt discount.
### 6.4 Subsequent Accounting

#### 6.4.1 Liability Component

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-12</strong> The excess of the principal amount of a liability component recognized in accordance with paragraph 470-20-25-23 over its carrying amount shall be amortized to interest cost using the interest method as described in paragraphs 835-30-35-2 through 35-4.</td>
</tr>
<tr>
<td><strong>35-13</strong> For purposes of applying the interest method to a convertible debt instrument within the scope of the Cash Conversion Subsections, debt discounts and debt issuance costs shall be amortized over the expected life of a similar liability that does not have an associated equity component (considering the effects of embedded features other than the conversion option).</td>
</tr>
<tr>
<td><strong>35-14</strong> If, under Subtopic 820-10, an issuer uses a valuation technique consistent with an income approach to measure the fair value of the liability component at initial recognition, the issuer shall consider the periods of cash flows used in the fair value measurement when determining the appropriate discount amortization period.</td>
</tr>
<tr>
<td><strong>35-16</strong> The expected life of the liability component shall not be reassessed in subsequent periods unless the terms of the instrument are modified. Therefore, the reported interest cost for an instrument within the scope of the Cash Conversion Subsections shall be determined based on its stated interest rate once the debt discount has been fully amortized.</td>
</tr>
</tbody>
</table>

After initial recognition, the issuer measures the liability component of convertible debt subject to the CCF guidance in ASC 470-20 at amortized cost by applying the interest method in ASC 835. This means that the excess of the principal amount to be repaid at the end of the expected life of a similar hypothetical nonconvertible debt over the initial carrying amount of the liability component is treated as a debt discount. As indicated in ASC 835-30-35-2, under the interest method, the amortization of the debt discount is computed “in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period.”

The issuer amortizes the debt discount and any transaction costs allocated to the liability component (i.e., the debt issuance costs) by using the interest method over the expected life of a similar hypothetical nonconvertible debt instrument. It determines the expected life by considering all substantive terms and features (e.g., substantive puts or calls) of the convertible debt other than the conversion feature (see Section 6.3.2.4.1). The amortization period is not subsequently reassessed unless the terms of the instrument are modified.

The periodic amortization of the debt discount and any debt issuance costs adds a noncash component to interest expense that reflects the difference between the cash coupon rate on the convertible debt and the effective interest rate on the liability component. Paragraph B14 of FSP APB 14-1 notes that this “treatment is consistent with the objective that an issuer's reported interest cost from convertible debt instruments within the scope of [the CCF guidance in ASC 470-20] should reflect its nonconvertible debt borrowing rate” (see Section 6.1.2).

If the issuer determines the initial fair value of the liability component by using an income approach (e.g., discounted cash flows), it estimates that fair value on the basis of contractual cash flows of a similar hypothetical nonconvertible debt instrument over its expected life. In this circumstance, the entity uses the same expected-life assumption in determining the appropriate amortization period for the debt discount and any associated debt issuance costs after initial recognition.
The method of determining the amortization period over the liability component’s expected term is unique to instruments within the scope of the CCF guidance in ASC 470-20. For instruments outside the scope of the CCF guidance, the amortization period is usually the contractual life or the earliest noncontingent put date unless special requirements apply. Paragraph B15 of FSP APB 14-1 states, in part:

The Board is aware that for debt instruments containing prepayment features, different accounting policies have been applied in practice for purposes of estimating the amortization period for discounts, premiums, and deferred transaction costs under [ASC 835-30]. The guidance (in the Cash Conversion subsections of ASC 470-20) on determining an appropriate discount amortization period is not intended to be a broad-based interpretation applicable to debt instruments that are not within the scope of [this guidance].

6.4.2 Equity Component

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-17</strong> The equity component (conversion option) shall not be remeasured as long as it continues to meet Subtopic 815-40’s conditions for equity classification.</td>
</tr>
<tr>
<td><strong>35-18</strong> A reclassification of the equity component (conversion option) would not affect the accounting for the liability component.</td>
</tr>
<tr>
<td><strong>35-19</strong> If Subtopic 815-40 requires the conversion option to be reclassified from stockholders’ equity to a liability measured at fair value (see the guidance beginning in paragraph 815-40-35-8), the difference between the amount previously recognized in equity and the fair value of the conversion option at the date of reclassification shall be accounted for as an adjustment to stockholders’ equity.</td>
</tr>
<tr>
<td><strong>35-20</strong> If Subtopic 815-40 requires that a conversion option that was previously reclassified from stockholders’ equity be subsequently reclassified back into stockholders’ equity, gains or losses recorded to account for the conversion option at fair value during the period it was classified as a liability shall not be reversed.</td>
</tr>
</tbody>
</table>

After initial recognition, the issuer does not remeasure the equity component of convertible debt subject to the CCF guidance in ASC 470-20 unless the conversion feature no longer meets the equity classification conditions in ASC 815-40. In a manner consistent with the guidance in ASC 815-40-35-8, the issuer reassesses the classification of the equity component of a convertible debt instrument accounted for under the CCF guidance in ASC 470-20 as of each balance sheet date. If an event causes a change in the required classification, the contract is reclassified as of the date of the event.

If the conversion feature no longer meets the equity classification conditions in ASC 815-40 (e.g., because the issuer has voluntarily issued equity shares so that it no longer has a sufficient number of authorized and unissued shares to settle the convertible debt in shares upon conversion), the issuer reclassifies the previously recognized equity component as a liability. The liability and equity components of the convertible debt instrument are not recombined; instead, the liability component and the conversion feature continue to be treated as two separate units of account. The entity continues to accrete the liability component and accounts for the previously recognized equity-classified conversion feature as a liability at fair value, with changes in fair value recognized in earnings under ASC 815-40, as long as the feature does not meet the equity classification conditions in ASC 815-40.

An issuer would not reclassify the equity component as a liability merely because it has decided to settle the instrument in cash upon conversion (or has a history of cash settlements of similar contracts) as long as the conversion feature continues to meet the criteria for equity classification in ASC 815-40 (e.g., the issuer could not be forced to cash settle the feature upon conversion).
6.5 Derecognition

6.5.1 General Approach

**ASC 470-20**

40-19 If an instrument within the scope of the Cash Conversion Subsections is derecognized, an issuer shall allocate the consideration transferred and transaction costs incurred to the extinguishment of the liability component and the reacquisition of the equity component.

40-20 Regardless of the form of consideration transferred at settlement, which may include cash (or other assets), equity shares, or any combination thereof, that allocation shall be performed as follows:

a. Measure the fair value of the consideration transferred to the holder. If the transaction is a modification or exchange that results in derecognition of the original instrument, measure the new instrument at fair value (including both the liability and equity components if the new instrument is also within the scope of the Cash Conversion Subsections).

b. Allocate the fair value of the consideration transferred to the holder between the liability and equity components of the original instrument as follows:

1. Allocate a portion of the settlement consideration to the extinguishment of the liability component equal to the fair value of that component immediately before extinguishment.

2. Recognize in the statement of financial performance as a gain or loss on debt extinguishment any difference between (i) and (ii):
   i. The consideration attributed to the liability component.
   ii. The sum of both of the following:
      01. The net carrying amount of the liability component
      02. Any unamortized debt issuance costs.

3. Allocate the remaining settlement consideration to the reacquisition of the equity component and recognize that amount as a reduction of stockholders' equity.

40-21 If the derecognition transaction includes other unstated (or stated) rights or privileges in addition to the settlement of the convertible debt instrument, a portion of the settlement consideration shall be attributed to those rights and privileges based on the guidance in other applicable U.S. GAAP.

40-22 Transaction costs incurred with third parties other than the investor(s) that directly relate to the settlement of a convertible debt instrument within the scope of the Cash Conversion Subsections shall be allocated to the liability and equity components in proportion to the allocation of consideration transferred at settlement and accounted for as debt extinguishment costs and equity reacquisition costs, respectively.
When an instrument within the scope of the CCF guidance is derecognized (e.g., because it is converted or otherwise settled), the transaction is accounted for as an extinguishment of the liability component (a debt extinguishment) and the reacquisition of the equity component (an equity transaction) irrespective of the form of settlement (e.g., cash or shares or a combination of both). Transactions that could cause an instrument within the scope of the CCF guidance in ASC 470-20 to be derecognized include those in which the issuer is relieved of its obligations through:

- The conversion of the instrument in accordance with its contractual terms.
- A settlement of the convertible debt instrument in which cash is paid to the creditor (e.g., the exercise of an embedded call or put option), which results in the expiration of the conversion feature in accordance with the contractual terms.
- The reacquisition of the convertible debt instrument before its maturity (e.g., in an open-market repurchase of outstanding convertible debt) irrespective of whether the instrument is cancelled or held in treasury.
- A modification of the instrument’s contractual terms if the modification is treated as an extinguishment under ASC 470-50.
- An exchange of the instrument for another instrument if the exchange is treated as an extinguishment under ASC 470-50.

Upon derecognition of the instrument, the fair value of the consideration transferred to the holders (e.g., cash, other assets, equity shares, services, or a combination thereof) is allocated between the two components by using the same method as that for allocating the original issuance proceeds between the two components irrespective of whether the issuer transfers cash, shares, or a combination of cash and shares upon conversion. The portion of the consideration allocated to the extinguishment of the liability component is equal to the fair value of that component immediately before conversion. The amount of consideration that remains is allocated to the reacquisition of the equity component. No gain or loss is recognized for the amount allocated to the equity component. (ASC 260-10-S99-2 does not apply to the settlement of the equity component.)

Third-party transaction costs that are directly related to the settlement are allocated to the liability component as debt extinguishment costs in proportion to the allocation of consideration transferred to the liability component at settlement. The remaining third-party transaction costs that are directly related to the settlement are treated as equity reacquisition costs.

Any difference between (1) the amount of settlement consideration plus the costs allocated to the liability component and (2) the liability component’s net carrying amount (including any remaining unamortized discount and debt issuance costs) is recognized as a gain or loss upon debt extinguishment. Accordingly, the settlement of a convertible debt instrument subject to the CCF guidance in ASC 470-20 typically results in a gain or loss upon extinguishment.
6.5.2 Induced Conversions

**ASC 470-20**

40-26 An entity may amend the terms of an instrument within the scope of the Cash Conversion Subsections to induce early conversion, for example, by offering a more favorable conversion ratio or paying other additional consideration in the event of conversion before a specified date. In those circumstances, the entity shall recognize a loss equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of consideration issuable in accordance with the original conversion terms. The settlement accounting (derecognition) treatment described in paragraph 470-20-40-20 is then applied using the fair value of the consideration that was issuable in accordance with the original conversion terms. The guidance in this paragraph does not apply to derecognition transactions in which the holder does not exercise the embedded conversion option.

To induce conversion of convertible debt instruments before a specified date (see Section 4.5.4), issuers sometimes change the conversion terms (e.g., reduce the conversion price) or give the holders additional consideration (e.g., cash, equity shares, warrants, other securities).

The wording of the scope guidance on induced conversions of convertible debt within the scope of the CCF guidance differs from that on induced conversions of traditional convertible debt (see Section 4.5.4.1). ASC 470-20-40-14 specifies that the induced conversion guidance on traditional convertible debt applies to an exchange of a convertible debt instrument for shares, even if the exchange does not involve the legal exercise of the contractual conversion privileges included in the terms of the debt. However, ASC 470-20-40-26 notes that the induced conversion guidance on convertible debt within the scope of the CCF guidance does not apply to derecognition transactions in which the holder does not exercise the embedded conversion option. We believe that an entity should consider its specific facts and circumstances and the substance of the transaction in evaluating whether an exchange that does not involve the legal exercise of contractual conversion privileges should be accounted for as an induced conversion under ASC 470-20-40-26.

If a holder exercises its option in an induced conversion of a debt instrument within the scope of the CCF guidance in ASC 470-20, the issuer would apply the following two-step model to account for the conversion:

- **Step 1 — Determine the amount of the inducement expense.** Recognize a loss (an inducement expense) equal to the excess of (1) the fair value of the consideration transferred over (2) the fair value of the consideration that would have been issuable under the original conversion terms. In a manner consistent with the guidance in ASC 470-20-40-16, fair value is determined as of the date the inducement offer is accepted by the convertible debt holder (such as the conversion date or the date the holder enters into a binding agreement to convert, as applicable; see Section 4.5.4 for further discussion).

- **Step 2 — Determine the amount of any debt extinguishment gain or loss.** Allocate the fair value of consideration issuable under the original terms between (1) the extinguishment of the liability component and (2) the reacquisition of the original instrument's equity component in accordance with ASC 470-20-40-20. The fair value of the liability component is allocated to the liability component and compared with the net carrying amount of the liability component in the determination of a gain or loss upon debt extinguishment. Any remaining amount of the fair value of consideration issuable under the original terms is allocated to the equity component. Said differently, the issuer applies the derecognition guidance in ASC 470-20-40-20 by using the fair value of the consideration that was issuable under the original conversion terms rather than the fair value of the consideration actually transferred to the holder.
Paragraph B18 of FSP APB 14-1 states:

The Board decided that if an entity amends the terms of a convertible debt instrument within the scope of [the CCF guidance in ASC 470-20] to induce early conversion, the entity must recognize a loss equal to the fair value of all securities and other consideration in excess of the fair value of the consideration issuable pursuant to the original conversion terms. That treatment is consistent with the accounting for such additional consideration under [ASC 470-20-40-16]. No portion of the additional consideration paid to the holder to induce early conversion is attributed to equity because that payment embodies an incremental financing cost.

In some circumstances, the fair value of the liability component exceeds the fair value of the consideration issuable under the original terms. In such cases, questions may arise about the method of allocating the fair value of consideration issuable under the original terms between the liability and equity components of the original instrument. We believe that the issuer cannot allocate an amount greater than the fair value of consideration issuable under the original terms in determining the debt extinguishment gain or loss.

If the fair value of the liability component exceeds the fair value of consideration issuable under the original terms, the entity determines the debt extinguishment gain or loss (in step 2) by comparing the carrying amount of the liability component with the fair value of consideration issuable under the original terms (rather than the fair value of the liability component). In this circumstance, no amount is allocated to the equity component because all of the fair value of consideration issuable under the original terms is allocated to the liability component. In certain circumstances, this method could result in a net gain for the debtor (i.e., a debt extinguishment gain that exceeds the inducement loss). We have confirmed this guidance in discussions with the FASB staff.

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**Example 6-8**

**Induced Conversion of Convertible Debt With CCF**

On January 1, 20X1, Entity A issues at par a 5 percent convertible bond with a $1,200 face amount that will mature on December 31, 20X8. The bond is convertible into A's common shares at a price of $60 per share. Because the stated terms of the bond permit A to settle in cash upon conversion, A applies ASC 470-20-25-23 and allocates $1,000 to the bond's liability component and $200 to its equity component.

On January 1, 20X6, the liability component has a carrying amount of $1,110 and a fair value of $1,150. To induce bondholders to convert their bonds promptly, A reduces the conversion price to $40 for bondholders that convert before February 29, 20X6 (within 60 days). On the conversion date, the market price of A's common stock is $50 per share.

Upon conversion of the bonds, a step 1 inducement loss is calculated as follows:

**A. Fair Value of Shares Issued Upon Inducement**

Calculated as:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face amount</td>
<td>$1,200</td>
</tr>
<tr>
<td>New conversion price</td>
<td>÷ 40</td>
</tr>
<tr>
<td>Number of common shares issued upon conversion</td>
<td>= 30</td>
</tr>
<tr>
<td>Price per common share</td>
<td>× 50</td>
</tr>
<tr>
<td></td>
<td>= $1,500</td>
</tr>
</tbody>
</table>

---
Example 6-8 (continued)

B. Fair Value of Shares Issuable Under Original Terms

Calculated as:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face amount</td>
<td>$ 1,200</td>
</tr>
<tr>
<td>Original conversion price</td>
<td>60</td>
</tr>
<tr>
<td>Number of common shares issued upon conversion</td>
<td>20</td>
</tr>
<tr>
<td>Price per common share</td>
<td>50</td>
</tr>
<tr>
<td><strong>Step 1 induced conversion loss (A – B)</strong></td>
<td><strong>$ 500</strong></td>
</tr>
</tbody>
</table>

The step 2 debt extinguishment gain is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of liability component (C)</td>
<td>$ 1,110</td>
</tr>
<tr>
<td>Fair value of shares issuable under original terms (B)</td>
<td>$ 1,000</td>
</tr>
<tr>
<td><strong>Step 2 debt extinguishment gain (C – B)</strong></td>
<td><strong>$ 110</strong></td>
</tr>
</tbody>
</table>

The debt extinguishment gain or loss in step 2 is not calculated by comparing the liability component’s carrying amount ($1,110) with its fair value ($1,150) but instead is calculated as the difference between the carrying amount of the liability component and the fair value of consideration issuable under the original terms.

Entity A would record the following entries upon the induced conversion:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible debt — liability component</td>
<td>1,110</td>
</tr>
<tr>
<td>Induced conversion loss</td>
<td>500</td>
</tr>
<tr>
<td>Common stock</td>
<td>1,500</td>
</tr>
<tr>
<td>Debt extinguishment gain</td>
<td>110</td>
</tr>
</tbody>
</table>

6.5.3 Modifications and Exchanges

ASC 470-20

40-23 The guidance in the Cash Conversion Subsections does not affect an issuer’s determination of whether a modification (or exchange) of an instrument within the scope of those Subsections should be accounted for as an extinguishment of the original instrument or a modification to the terms of the original instrument. An issuer shall apply the guidance in Subtopic 470-50 to make that determination.

If a convertible debt instrument is modified or exchanged for another instrument, the issuer applies ASC 470-50 to determine whether the modification or exchange should be accounted for as an extinguishment or a modification (see Section 4.5.6) unless it is a TDR that should be evaluated under ASC 470-60 (see Section 4.5.7).

ASC 470-50 does not explicitly address whether and, if so, how the separation of a CCF affects an issuer’s assessment of whether the terms are substantially different. In the application of the 10 percent cash flow test in ASC 470-50-40-10, it is reasonable for entities to discount the cash flows by using an original effective interest rate that reflects the separation of the CCF (i.e., the discount rate is the effective interest rate of the original debt instrument after separation of the CCF; see Section 4.5.4). However, in the determination of whether the change in the fair value of an embedded conversion option is at least 10 percent of the carrying amount of the original debt instrument immediately before
the modification or exchange, it is reasonable to add back any discount created by the CCF, since the purpose is to assess the significance of the change in fair value compared with the carrying amount of the instrument as a whole. In other words, this test is performed as if the convertible debt instrument had never been separated into component parts under the CCF guidance, which requires the determination of a pro forma net carrying amount of the convertible debt instrument had separation not occurred.

6.5.3.1 Extinguishment Accounting

If a modification or exchange of an instrument subject to the CCF guidance in ASC 470-20 must be accounted for as an extinguishment, the issuer applies the derecognition guidance described in Section 6.5.1 to the transaction. Under that guidance, the fair value of the consideration transferred is allocated upon derecognition between the liability and equity components of the existing instrument in a manner consistent with the allocation of proceeds upon the initial issuance of a convertible debt instrument within the scope of the CCF guidance in ASC 470-20. Thus, to apply extinguishment accounting to a convertible debt instrument within the scope of the CCF guidance in ASC 470-20, the issuer performs the following steps:

1. The issuer determines the fair value of the consideration transferred upon derecognition. This amount includes (a) the fair value of the “new” instrument that has been modified or obtained in the exchange plus (b) the amount of any cash paid to the holder less (c) the amount of any cash received from the holder in the derecognition transaction. If the parties exchange other rights or privileges as part of the transaction, the issuer recognizes them appropriately (e.g., by allocating part of the consideration transferred to them, if applicable).

2. The issuer allocates the fair value of the consideration transferred between the extinguishment of the existing instrument’s liability component and the reacquisition of its equity component:
   a. The amount allocated to the extinguishment of the liability component equals the fair value of the liability component immediately before the derecognition transaction. The issuer recognizes an extinguishment gain or loss for any difference between the amount of consideration allocated to the liability component and the instrument’s net carrying amount (including any unamortized debt issuance costs or debt discount).
   b. The remaining amount of the fair value of the consideration transferred is allocated to the equity component and treated as a reduction of stockholders’ equity.

3. The issuer treats the debt instrument that has been modified or obtained in the exchange as a newly recognized instrument under GAAP and initially records it at fair value (ASC 470-50-40-13). If the new instrument does not require or permit cash settlement upon conversion, it would be outside the scope of the CCF guidance in ASC 470-20, and other GAAP would apply.

4. In accordance with ASC 470-50-40-18(a), the issuer treats any third-party transaction costs that are directly related to the exchange or modification as issuance costs of the new instrument. Under ASC 470-20-30-31, if the new instrument is within the scope of the CCF guidance in ASC 470-20, the transaction costs are allocated to the liability and equity components of the new instrument in proportion to the “proceeds” (i.e., fair value) allocated to it.
6.5.3.2 Modification Accounting

If a modification or exchange of an instrument subject to the CCF guidance in ASC 470-20 must be accounted for as a modification, the issuer would not remeasure the instrument to its current fair value but instead should perform the following steps if the convertible debt instrument remains subject to the CCF guidance:

1. The issuer should reassess the effective life of the instrument under ASC 470-20-35-15 (see Section 6.3.2.4.1 for a discussion of how to estimate the expected life).

2. If the terms of the embedded conversion option are modified, the issuer should calculate the increase or decrease in the option's fair value in accordance with ASC 470-50-40-15 as the difference between its fair value immediately before and after the modification or exchange. An increase in the option's fair value reduces the carrying amount of the liability component (increasing a debt discount), with a corresponding increase to APIC. No accounting recognition is given to a decrease in the option's fair value.

3. The issuer should make a prospective yield adjustment in accordance with ASC 470-20-40-23 and ASC 470-50-40-14 by updating the effective interest rate of the liability component prospectively on the basis of (a) the liability component's adjusted carrying amount and (b) the modified cash flows.

6.5.3.3 Convertible Debt Modified to Remove CCF

Paragraph B17 of FSP APB 14-1 states, in part:

If an instrument within the scope of the Cash Conversion Subsections is modified such that the conversion option no longer requires or permits cash settlement upon conversion, the components of the instrument would continue to be accounted for separately unless the original instrument is required to be derecognized under Subtopic 470-50. If an instrument is modified or exchanged in a manner that requires derecognition of the original instrument under Subtopic 470-50 and the new instrument is a convertible debt instrument that may not be settled in cash upon conversion, the new instrument would not be subject to the guidance in the Cash Conversion Subsections and other U.S. GAAP would apply (for example, paragraph 470-20-25-12).
and equity components should not be recombined at a later date due to a modification that is not accounted for as an extinguishment. Rather, the liability component should continue to be accreted to its principal amount based on the modified terms of the instrument.

### 6.5.3.4 Convertible Debt Modified to Add CCF

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-25</strong> If a convertible debt instrument that is not within the scope of the Cash Conversion Subsections is modified such that it becomes subject to the Cash Conversion Subsections, an issuer shall apply the guidance in Subtopic 470-50 to determine whether the original instrument is required to be derecognized. If the modification is not accounted for by derecognizing the original instrument, the issuer shall apply the guidance in the Cash Conversion Subsections prospectively from the date of the modification. In that circumstance, the liability component is measured at its fair value as of the modification date. The carrying amount of the equity component represented by the embedded conversion option is then determined by deducting the fair value of the liability component from the overall carrying amount of the convertible debt instrument as a whole. At the modification date, a portion of any unamortized debt issuance costs shall be reclassified and accounted for as equity issuance costs based on the proportion of the overall carrying amount of the convertible debt instrument that is allocated to the equity component.</td>
</tr>
</tbody>
</table>

If a convertible debt instrument outside the scope of the CCF guidance is modified so that it becomes subject to the guidance, the issuer applies the guidance prospectively. If the modification or exchange is accounted for as an extinguishment, the convertible debt is accounted for as a newly issued instrument with a CCF. If the modification or exchange is accounted for as a modification, a portion of the debt's current net carrying amount equal to the modification-date fair value of the liability component becomes the carrying amount of the liability component. Any remaining portion of the current net carrying amount is allocated to the equity component. Further, a portion of any remaining unamortized debt issuance cost is reclassified to equity as an equity issuance cost in proportion to the current net carrying amount allocated to the equity component.

### 6.6 Presentation and Disclosure

#### 6.6.1 Presentation on a Classified Balance Sheet

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-3</strong> The guidance in the Cash Conversion Subsections does not affect an issuer's determination of whether the liability component should be classified as a current liability or a long-term liability. For purposes of applying other applicable U.S. GAAP to make that determination, all terms of the convertible debt instrument (including the equity component) shall be considered. Additionally, the balance sheet classification of the liability component does not affect the measurement of that component under paragraphs 470-20-35-12 through 35-16.</td>
</tr>
</tbody>
</table>

In determining whether the liability component of convertible debt within the scope of the CCF guidance in ASC 470-20 should be classified as current or long-term on a classified balance sheet, the issuer considers all the terms of the debt, including the conversion feature. The separation of an equity component does not affect the issuer's determination of whether the liability component should be classified as current or noncurrent.

An issuer applies ASC 210-10-45 and ASC 470-10-45 to determine the appropriate balance sheet classification of debt. CCFs may cause debt that otherwise would have been classified as noncurrent to be classified as current. Convertible debt should be treated as debt with a demand provision under ASC 470-10-45-10 if the CCFs (1) permit the holder to convert at any time or within one year (or operating cycle, if longer) of the reporting date and (2) require the issuer to settle the accreted value in
cash (i.e., Instrument C as described in Section 6.1.3). Similarly, convertible debt that requires the issuer to settle the accreted value in cash should be treated as having a demand provision if (1) the conversion feature is contingent and (2) the contingency is met as of the balance sheet date. The liability component would be treated as debt that is due on demand even if the conversion option were out-of-the-money.

If convertible debt instruments subject to the CCF guidance allow the issuer to pay the accreted value in cash or stock or any combination thereof (i.e., Instrument X), the diluted EPS treatment depends on whether the issuer overcomes the presumption of share settlement of the accreted value. If that presumption is overcome, the entity calculates the dilutive effect of the convertible debt instrument by using the treasury stock method (i.e., the entity uses the dilutive EPS guidance applicable to Instrument C). An entity should determine the current versus noncurrent classification of the liability component in a manner consistent with its intended settlement for calculating diluted EPS. For example, it would generally be inappropriate to assume share settlement of the accreted value for balance sheet classification purposes and cash settlement of the accreted value for diluted EPS calculation purposes.

6.6.2 EPS Requirements

This section provides an overview of the EPS requirements that apply to convertible debt instruments subject to the CCF guidance in ASC 470-20. For additional discussion, see Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share.

6.6.2.1 Basic EPS

Provided that a convertible debt instrument within the scope of the CCF guidance in ASC 470-20 does not represent a participating security, basic EPS is affected as a result of (1) a reduction of the numerator (i.e., net income) due to the recognition of interest expense or an adjustment to the numerator due to the recognition of a gain or loss upon extinguishment and (2) an increase in the denominator if the convertible debt instrument has been settled in exchange for common stock (i.e., an increase in the weighted-average common shares outstanding calculated from the date the security is exchanged for common stock). If the cash convertible debt instrument meets the definition of a participating security, the entity must apply the two-class method to calculate basic EPS (see Chapter 5 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share).

Because the initial carrying amount of the liability component is less than its principal amount, a discount arises on issuance and is amortized under the interest method (see Section 6.4.1). This amortization will increase the reported amount of interest expense, thereby reducing the numerator in the calculation of basic EPS.

As discussed in Section 6.5.3.2, modifications or exchanges involving cash convertible debt instruments that do not result in extinguishment accounting may affect both the carrying amount of the liability component and the effective interest rate used to amortize the discount between the carrying amount and principal amount of the liability component. Thus, a modification or exchange could also affect the numerator in the calculation of basic EPS.

Upon any settlement of a cash convertible debt instrument, ASC 470-20-40-20 requires an issuer to allocate the total consideration between the liability and equity components (see Section 6.5.1). Such an allocation will almost always result in the recognition of an extinguishment gain or loss in earnings in connection with the settlement of the liability component. This gain or loss will affect the numerator in the calculation of basic EPS. See Section 6.5.2 for a discussion of the impact of an induced conversion.

Because interest expense and extinguishment gains and losses on cash convertible debt instruments affect net income, no specific adjustments should be made to the numerator in the calculation of basic EPS.
6.6.2.2  **Diluted EPS**

6.6.2.2.1 Methods Applicable to Cash Convertible Debt Instruments

A conversion of a cash convertible debt instrument in accordance with its original conversion terms may be settled in cash, common stock, or a combination thereof. An entity that has the option of settling all or a portion of a cash convertible debt instrument in cash or common stock must consider the guidance in ASC 260 on contracts that may be settled in stock or cash. As discussed in the guidance below, an entity that may elect to settle a contract in cash or common stock should assume that the contract will be settled in common stock for diluted EPS purposes. That presumption may be overcome on the basis of past experience or a stated policy.

<table>
<thead>
<tr>
<th>ASC 260-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contracts That May Be Settled in Stock or Cash</strong></td>
</tr>
<tr>
<td><strong>45-45</strong></td>
</tr>
<tr>
<td><strong>45-46</strong></td>
</tr>
<tr>
<td><strong>55-32</strong></td>
</tr>
<tr>
<td><strong>55-36</strong></td>
</tr>
</tbody>
</table>

As noted in ASC 260-10-45-46, “[t]he presumption that the contract will be settled in common stock may be overcome if past experience or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.” Section 4.7.2.3 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share* discusses matters to be considered in each financial reporting period in the determination of whether the presumption of share settlement of a cash convertible debt instrument may be overcome.

The table below summarizes the diluted EPS methods that apply to cash convertible debt instruments within the scope of the Cash Conversion subsections of ASC 470-20. In this table, it is assumed that (1) the cash convertible debt instrument is not a participating security and (2) if the instrument is only contingently convertible, it must be included in the calculation of diluted EPS. See Deloitte's
For a discussion of the application of the two-class method of calculating diluted EPS (Section 5.5.2) and of contingently convertible debt instruments (Section 4.4.3), see Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share.

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Diluted EPS Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instrument B</td>
<td><strong>Entity Does Not Overcome Presumption of Share Settlement of the Entire Obligation</strong></td>
</tr>
<tr>
<td></td>
<td>If an entity is unable to overcome the presumption of share settlement of the entire obligation, it should apply the if-converted method to calculate diluted EPS. Under ASC 260-10-45-21, such a calculation must be based on the conversion terms that are most advantageous to the holder. See Section 4.9 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share for further discussion of the year-to-date calculations of diluted EPS.</td>
</tr>
<tr>
<td></td>
<td><strong>Entity Overcomes Presumption of Share Settlement of the Entire Obligation</strong></td>
</tr>
<tr>
<td></td>
<td>If an entity overcomes the presumption of share settlement of the entire obligation, the entity would assume, in calculating diluted EPS, that the entire obligation will be settled in cash upon conversion. In such circumstances, no adjustment should be made to the denominator in the calculation of diluted EPS. However, additional consideration is necessary because the accounting classification of the contract differs from the assumed method of settlement for diluted EPS purposes. Specifically, the entity would have been required to bifurcate the embedded conversion option if the contract had required cash settlement upon conversion. As a result, the entity should reduce the numerator for any decrease in net income that would have occurred during the period if the embedded conversion option had been classified as a derivative liability. We believe that an entity should only consider the impact of recognizing the embedded conversion option as a derivative under ASC 815-15. The entity should not consider the impact on net income that would have occurred if the entire convertible debt instrument had been recognized at fair value through earnings, since any change in the convertible debt instrument’s fair value arising from something other than the embedded conversion option should not affect the calculation of diluted EPS. The numerator should not be adjusted for any increase in net income that would have occurred during the period if the embedded conversion option had been classified as an embedded derivative liability. See further discussion in Section 4.7.3.2.3 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.</td>
</tr>
<tr>
<td>Instrument C</td>
<td>ASC 260-10-55-84A states that “[t]he if-converted method should not be used to determine the earnings-per-share implications of convertible debt with the characteristics [of Instrument C].” However, the entity must still consider whether it can overcome the presumption of share settlement of the conversion spread.</td>
</tr>
<tr>
<td></td>
<td><strong>Entity Does Not Overcome Presumption of Share Settlement of the Conversion Spread</strong></td>
</tr>
<tr>
<td></td>
<td>If an entity is unable to overcome the presumption of share settlement of the conversion spread, in accordance with ASC 260-10-55-84A, (1) the numerator in the calculation of diluted EPS should not be adjusted for the cash-settled portion of the instrument and (2) the conversion spread should be included in diluted EPS by using the treasury stock method in the same manner as if the embedded conversion option was a freestanding written call option on the entity’s common shares. Under ASC 260-10-45-21, the calculation of diluted EPS must be based on the conversion terms that are most advantageous to the holder. See Section 4.9 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share for further discussion of the year-to-date calculations of diluted EPS.</td>
</tr>
<tr>
<td></td>
<td>Note that ASC 260-10-55-84A indicates that the number of incremental shares added to the denominator is calculated on the basis of the average market price of the common shares during the financial reporting period. This guidance is consistent with the application of the treasury stock method (i.e., the proceeds received upon exercise of a written option to sell common shares are used to repurchase such shares on the basis of the average market price during the period). We believe that the average market price is used in this example because the conversion price in the convertible debt instrument is substantively akin to proceeds. However, we do not believe that the FASB intended to require this approach. Rather, for Instrument C, since there are no proceeds that the entity actually receives upon conversion...</td>
</tr>
</tbody>
</table>
## Entity Overcomes Presumption of Share Settlement of the Conversion Spread

If an entity overcomes the presumption of share settlement of the conversion spread, the entity would assume, in calculating diluted EPS, that the entire obligation will be settled in cash upon conversion. In such circumstances, no adjustment should be made to the denominator in the calculation of diluted EPS. However, additional consideration is necessary because the accounting classification of the contract differs from the assumed method of settlement for diluted EPS purposes. Specifically, the entity would have been required to bifurcate the embedded conversion option if the contract had required cash settlement upon conversion. As a result, the entity should reduce the numerator for any decrease in net income that would have occurred during the period if the embedded conversion option had been classified as a derivative liability. We believe that an entity should only consider the impact of recognizing the embedded conversion option as a derivative under ASC 815-15. The entity should not consider the impact on net income that would have occurred if the entire convertible debt instrument had been recognized at fair value through earnings, since any change in the convertible debt instrument's fair value arising from something other than the embedded conversion option should not affect the calculation of diluted EPS. The numerator should not be adjusted for any increase in net income that would have occurred during the period if the embedded conversion option had been classified as an embedded derivative liability. See further discussion in Section 4.7.3.2.3 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share.

## Entity Overcomes Presumption of Share Settlement of the Accreted Value

If an entity has a reasonable basis for concluding that it would settle the accreted value of the debt obligation in cash (i.e., on the basis of a “stated policy” or past practice), the entity should treat the convertible debt instrument in the same manner as Instrument C. Therefore, no adjustment should be made to the numerator, and the entity should apply the treasury stock method to calculate the diluted effect of the conversion spread. Under ASC 260-10-45-21, the calculation of diluted EPS must be based on the conversion terms that are most advantageous to the holder. See Section 4.9 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share for further discussion of the year-to-date calculations of diluted EPS.

## Entity Overcomes Presumption of Share Settlement of the Entire Obligation

If an entity overcomes the presumption of share settlement of the entire obligation, the entity would assume, in calculating diluted EPS, that the entire obligation will be settled in cash upon conversion. Therefore, in such circumstances, the entity should treat the convertible debt instrument in the same manner as it would treat Instruments B and C when cash settlement of the entire obligation is assumed for diluted EPS purposes.
Connecting the Dots

Although the table above describes how an entity should account for diluted EPS when it overcomes the presumption of share settlement and therefore assumes cash settlement of the entire obligation, it is generally not appropriate to conclude that the entire instrument will be settled in cash in the calculation of diluted EPS. As discussed in Section 4.7.2.3 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share, it is difficult for an entity to assert that it has the intent and ability to cash-settle an instrument for which there is no limit on the amount of cash that would be due upon settlement.

Entities should disclose their intent and judgment regarding whether cash convertible debt instruments are assumed to be settled in cash or shares when such judgment is material to reported diluted EPS.

6.6.2.3 Out-of-the-Money Conversion Options

A holder of a cash convertible debt instrument could exercise the embedded conversion option when it is out-of-the-money. Depending on the terms of the convertible debt instrument, the monetary value of the consideration paid by the issuing entity to satisfy the conversion may differ depending on the settlement method. The terms of some cash convertible debt instruments specify that if the issuing entity chooses to settle a conversion entirely in cash, it must pay the holder no less than the principal amount that is otherwise due on maturity. However, if the entity chooses to settle the conversion in common shares, it is only obliged to deliver a number of common shares based on the original conversion terms. For example, assume that an entity issues a cash convertible debt instrument with a principal amount of $1,000. The terms specify that if the holder exercises the conversion option and the entity elects to pay the entire obligation in cash, it must pay no less than $1,000. Further, assume that the holder exercises the instrument when the conversion value is $900 on the basis of the fair value of the number of the entity’s common shares that would be delivered on conversion. If the entity chooses to settle the entire obligation in cash, it must pay $1,000. However, if the entity can choose to settle the entire obligation in common shares, which would be the case for Instruments B and X, it must only deliver a number of common shares with a fair value of $900. Thus, the monetary value paid on conversion differs because of the $1,000 “floor” on the cash amount payable on conversion that is included in the settlement terms of the instrument.

Questions have arisen regarding the method an issuing entity should use to calculate diluted EPS when cash convertible debt instruments with the characteristics described above are issued in the form of Instrument X. As discussed in the table above, when an entity does not conclude that it would settle the entire obligation underlying Instrument X in cash, which is typically the case, it must use judgment to determine whether to apply the if-converted method or treasury stock method to calculate diluted EPS. In financial reporting periods in which the conversion option is out-of-the-money, upon any conversion by the holder (which must be assumed for diluted EPS purposes), the entity would be economically motivated to elect to settle the entire obligation in common shares, since the fair value of the common shares issued on conversion would be less than the principal amount otherwise payable in cash. This would suggest that the entity should assume share settlement of the entire obligation and apply the if-converted method to calculate diluted EPS for any financial reporting period for which the conversion option is out-of-the-money. The if-converted method would always be more dilutive than the treasury stock method in such cases, since the treasury stock method never produces a dilutive result when an option is out-of-the-money.

While the if-converted method may be applied in such circumstances, an entity is not required to apply this method solely because the conversion option is out-of-the-money. Rather, the entity may analyze Instrument X for diluted EPS purposes at inception (when the conversion option typically is out-of-the-money), and in each subsequent financial reporting period, on the basis of how it would settle an in-the-
money conversion. Under this approach, if an entity has previously used the treasury stock method to calculate diluted EPS for Instrument X, the entity is not required to apply the if-converted method simply because the conversion option becomes out-of-the-money. There are several reasons for this conclusion. First, the conversion option in Instrument X is generally out-of-the-money in the period of issuance. ASC 260 does not require an entity to apply the if-converted method to Instrument X in the financial reporting period in which it was issued. Second, while ASC 260 requires an entity to include any dilutive effect under the if-converted method of calculation if the conversion option is out-of-the-money, this requirement is only relevant when an entity applies the if-converted method. ASC 260 does not require an entity to apply the if-converted method solely because a conversion option is out-of-the-money (and such application is not intuitive since it would be uneconomical for the holder to convert the instrument). Lastly, when the FASB issued FSP APB 14-1 (codified in ASC 470-20), it was well acknowledged that entities would be eligible to apply the treasury stock method to cash convertible instruments issued in the form of Instrument X.

**Connecting the Dots**

The same issue related to diluted EPS generally does not exist for Instruments B and C. For Instrument B, an entity must always apply the if-converted method if it does not overcome the presumption of share settlement of the entire obligation. As discussed in Section 4.7.2.3 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*, since it is difficult for an entity to assert its intent and ability to cash-settle the entire obligation, an entity that has issued Instrument B will generally always apply the if-converted method. For Instrument C, an entity must only determine whether to apply the treasury stock method or the diluted EPS accounting approach for contracts that are classified as equity instruments but assumed to be cash-settled for diluted EPS purposes. Each approach only reflects the dilutive effect of the conversion value. If the conversion value is out-of-the-money, the conversion will involve only a settlement of the accreted value for cash and the entity will not be required to make any adjustment in the calculation of diluted EPS. There is no incremental impact on the calculation of diluted EPS because there is no conversion value to reflect under the treasury stock method when the conversion option is out-of-the-money.

**6.6.2.4 Consideration of Extinguishment Gains and Losses**

The derecognition model in ASC 470-20 typically results in the recognition of an extinguishment gain or loss in earnings in the financial reporting period in which a cash convertible debt instrument is converted in accordance with its original conversion terms. In such circumstances, questions have arisen about whether (1) a hypothetical gain or loss should be included as an adjustment to the numerator when the if-converted method or treasury stock method is applied to a cash convertible debt instrument and (2) a recognized extinguishment gain or loss should be reversed from the numerator when the if-converted or treasury stock method is applied to a cash convertible debt instrument that was settled during a financial reporting period.

When applying the if-converted method to Instrument B or X to calculate diluted EPS, an entity should not adjust the numerator for any extinguishment gain or loss that would have been recognized if an outstanding Instrument B or X had been converted at the beginning of the reporting period (or the date of issuance, if later) and should reverse from the numerator any gain or loss that was recognized for an Instrument B or X that was extinguished during the financial reporting period. See further discussion in Section 4.4.2.2.4 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

When applying the treasury stock method to Instrument C in calculating diluted EPS, an entity should only adjust the denominator, if the effect is dilutive. Such application is consistent with ASC 260-10-55-84A, which states that “[t]here would be no adjustment to the numerator in the diluted earnings-
per-share computation for the cash-settled portion of the instrument because that portion will always be settled in cash.” In essence, Instrument C is treated as comprising both a debt instrument and a written option to sell common stock for diluted EPS purposes; accordingly, the entity may only adjust the denominator in calculating diluted EPS. Therefore, in such circumstances, the entity (1) should not adjust the numerator for any Instrument C outstanding at the end of the period for any extinguishment gain or loss that would have been recognized if conversion had occurred at the beginning of the reporting period (or the date of issuance, if later) and (2) should not reverse from the numerator any gain or loss that was recognized for any Instrument C that was extinguished during the financial reporting period.

6.6.3 Disclosure

**Disclosure Objectives**

**10-2** The disclosure requirements of the Cash Conversion Subsections are intended to provide users of financial statements with both:

a. Information about the terms of convertible debt instruments within the scope of those Subsections

b. An understanding of how those instruments have been reflected in the issuer’s statement of financial position and statement of financial performance.

**50-3** An entity shall provide the incremental disclosures required by the guidance in this Section in annual financial statements for convertible debt instruments within the scope of the Cash Conversion Subsections that were outstanding during any of the periods presented.

**50-4** As of each date for which a statement of financial position is presented, an entity shall disclose all of the following:

a. The carrying amount of the equity component

b. For the liability component:
   1. The principal amount
   2. The unamortized discount
   3. The net carrying amount.

**50-5** As of the date of the most recent statement of financial position that is presented, an entity shall disclose all of the following:

a. The remaining period over which any discount on the liability component will be amortized

b. The conversion price and the number of shares on which the aggregate consideration to be delivered upon conversion is determined

c. For a public entity only, the amount by which the instrument’s if-converted value exceeds its principal amount, regardless of whether the instrument is currently convertible

d. All of the following information about derivative transactions entered into in connection with the issuance of instruments within the scope of the Cash Conversion Subsections regardless of whether such derivative transactions are accounted for as assets, liabilities, or equity instruments:
   1. The terms of those derivative transactions
   2. How those derivative transactions relate to the instruments within the scope of the Cash Conversion Subsections
   3. The number of shares underlying the derivative transactions
   4. The reasons for entering into those derivative transactions.

An example of a derivative transaction entered into in connection with the issuance of an instrument within the scope of the Cash Conversion Subsections is the purchase of call options that are expected to substantially offset changes in the fair value of the conversion option.
For each period for which a statement of financial performance is presented, an entity shall disclose both of the following:

a. The effective interest rate on the liability component for the period
b. The amount of interest cost recognized for the period relating to both the contractual interest coupon and amortization of the discount on the liability component.

ASC 470-20 includes incremental disclosure requirements for convertible debt instruments that are within the scope of its CCF guidance and were outstanding during any of the periods presented. The objective of these disclosure requirements is to inform financial statement users about (1) the terms of convertible debt instruments within the scope of the CCF guidance and (2) how those instruments have been reflected in the issuer’s statements of financial position and financial performance.

Below is a tabular overview of the incremental disclosure requirements applicable to instruments within the scope of the CCF guidance in ASC 470-20.

<table>
<thead>
<tr>
<th>Liability Component</th>
<th>Equity Component</th>
<th>Derivatives Executed at Inception</th>
</tr>
</thead>
<tbody>
<tr>
<td>Each balance sheet</td>
<td>• Principal amount</td>
<td>• Carrying amount</td>
</tr>
<tr>
<td></td>
<td>• Unamortized discount</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Net carrying amount</td>
<td></td>
</tr>
<tr>
<td>Most recent balance sheet</td>
<td>• Remaining amortization period</td>
<td>• Conversion price</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Number of shares on which the conversion value is determined</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The excess of the if-converted value over the principal amount, if any (public entities only)</td>
</tr>
<tr>
<td>Each income statement period</td>
<td>• Effective interest rate</td>
<td>• Terms</td>
</tr>
<tr>
<td></td>
<td>• Amount of recognized interest cost</td>
<td>• How they relate to the CCF instrument</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Number of underlying shares</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Reasons for execution</td>
</tr>
</tbody>
</table>

For a discussion of disclosure requirements that apply broadly to convertible instruments, including instruments within the scope of the CCF guidance, see Section 4.6.4.

The guidance in GAAP does not address whether the disclosure requirements related to fair value in ASC 825-10-50 apply to convertible debt instruments within the scope of the CCF guidance in ASC 470-20 as a whole or only to the liability component of such instruments. We believe that there are two acceptable views:

- The disclosure requirements in ASC 825-10-50 should be applied to the convertible debt instrument as a whole. Supporters of this view note that the disclosures in ASC 825-10-50 apply to liability-classified financial instruments and there is no specific scope exception in ASC 825-10-50 for the equity-classified component of an instrument.
Chapter 6 — Cash Conversion Features

- The disclosure requirements in ASC 825-10-50 should be applied only to the liability component. Proponents of this view note that these requirements are not applicable to equity-classified instruments under ASC 825-10-50-8(i), and they apply this scope exception to the equity component of instruments that have been separated into liability and equity components.

6.7 Comprehensive Example

6.7.1 Overview

ASC 470-20-55 contains a comprehensive example of how to apply the CCF guidance to a convertible debt instrument that has a 10-year contractual life and can be converted at any time into the equivalent of a fixed number of the issuer’s common shares. Because the issuer can elect to settle the entire if-converted value (i.e., the principal amount of the debt plus the conversion spread) in cash, common stock, or any combination thereof, the convertible debt instrument represents an Instrument X (as described in Section 6.1.3). Five years into the life of the instrument, the holders elect to convert. The example illustrates the recognition and initial measurement of the instrument’s liability and equity components and associated tax entries, subsequent accounting for the liability component, and derecognition entries upon the instrument’s conversion.

6.7.1.1 Assumptions

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-71 This Example illustrates the application of the guidance in the Cash Conversion Subsections. This Example makes all of the following assumptions:</td>
</tr>
<tr>
<td>a. The embedded conversion option does not require separate accounting as a derivative instrument under Subtopic 815-15 because it qualifies for the scope exception in paragraph 815-10-15-74.</td>
</tr>
<tr>
<td>b. On January 1, 2007, Entity A issues 100,000 convertible notes at their par value of $1,000 per note, raising total proceeds of $100,000,000.</td>
</tr>
<tr>
<td>c. The notes bear interest at a fixed rate of 2 percent per annum, payable annually in arrears on December 31, and are scheduled to mature on December 31, 2016.</td>
</tr>
<tr>
<td>d. Each $1,000 par value note is convertible at any time into the equivalent of 10 shares of Entity A’s common stock (that is, representing a stated conversion price of $100 per share).</td>
</tr>
<tr>
<td>e. The quoted market price of Entity A’s common stock is $70 per share on the date of issuance.</td>
</tr>
<tr>
<td>f. Upon conversion, Entity A can elect to settle the entire if-converted value (that is, the principal amount of the debt plus the conversion spread) in cash, common stock, or any combination thereof.</td>
</tr>
<tr>
<td>g. The notes do not contain embedded prepayment features other than the conversion option.</td>
</tr>
<tr>
<td>h. At issuance, the market interest rate for similar debt without a conversion option is 8 percent.</td>
</tr>
<tr>
<td>i. The par value of Entity A’s common stock is $0.01 per share.</td>
</tr>
<tr>
<td>j. The tax basis of the notes is $100,000,000.</td>
</tr>
<tr>
<td>k. Entity A is entitled to tax deductions based on cash interest payments.</td>
</tr>
<tr>
<td>l. Entity A’s tax rate is 40 percent.</td>
</tr>
<tr>
<td>m. On January 1, 2012, when the quoted market price of Entity A’s common stock is $140 per share, all holders of the convertible notes exercise their conversion options. Accordingly, those investors are entitled to aggregate consideration of $140,000,000 ($1,400 per note).</td>
</tr>
<tr>
<td>n. At settlement, the market interest rate for similar debt without a conversion option is 7.5 percent.</td>
</tr>
<tr>
<td>o. Entity A receives no tax deduction for the payment of consideration upon conversion ($140,000,000) in excess of the tax basis of the convertible notes ($100,000,000), regardless of the form of that consideration (cash or shares).</td>
</tr>
</tbody>
</table>

55-72 Transaction costs have been omitted from this Example and journal entry amounts in this Example have been rounded to the nearest thousand.
6.7.2 Recognition and Initial Measurement

**ASC 470-20**

**55-73** Upon issuance of the notes, the liability component is measured first, and the difference between the proceeds from the notes' issuance and the fair value of the liability is assigned to the equity component. The following illustrates how the fair value of the liability component might be calculated at initial recognition using a discount rate adjustment technique (an income approach). Depending on the terms of the instrument (for example, if the instrument contains prepayment features other than the embedded conversion option) and the availability of inputs to valuation techniques, it may be appropriate to determine the fair value of the liability component using an expected present value technique (an income approach), a valuation technique based on prices and other relevant information generated by market transactions involving comparable liabilities (a market approach) or both an income approach and a market approach.

**55-74** The fair value of the liability component can be estimated by calculating the present value of its cash flows using a discount rate of 8 percent, the market rate for similar notes that have no conversion rights, as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of the principal — $100,000,000 payable in 10 years</td>
<td>$46,319,349</td>
</tr>
<tr>
<td>Present value of interest — $2,000,000 payable annually in arrears for 10 years</td>
<td>$13,420,163</td>
</tr>
<tr>
<td>Total liability component</td>
<td>$59,739,512</td>
</tr>
<tr>
<td>Total equity component ($100,000,000 – $59,739,512)</td>
<td>$40,260,488</td>
</tr>
</tbody>
</table>

**55-75** Entity A would make the following journal entries at initial recognition.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>40,260,000</td>
</tr>
<tr>
<td>Debt</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>40,260,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>16,104,000</td>
</tr>
<tr>
<td>Deferred tax liability ($40,260,000 × 40%)</td>
<td>16,104,000</td>
</tr>
</tbody>
</table>

6.7.3 Subsequent Accounting

**ASC 470-20**

**55-76** The notes do not contain embedded prepayment features other than the conversion option, so Entity A concludes that the expected life of the notes is 10 years (consistent with the periods of cash flows used to measure the fair value of the liability component) for purposes of applying the interest method. During the 5-year period from January 1, 2007, through December 31, 2011, Entity A recognizes $26,304,228 of interest cost, consisting of $10,000,000 of cash interest payments and $16,304,228 of discount amortization under the interest method. During that period, Entity A recognizes $10,521,691 of income tax benefits, consisting of $4,000,000 of current tax benefits (the tax effect of deductions for cash interest payments) and $6,521,691 of deferred tax benefits (partial reversal of the deferred tax liability due to amortization of the debt discount).
While not shown in ASC 470-20-55-76, the accounting entry on December 31, 2007 (i.e., the end of the first year), would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense ([$100,000,000 - $40,260,000] × 8%)</td>
<td>4,779,200</td>
</tr>
<tr>
<td>Cash ($100,000,000 × 2%)</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>2,779,200</td>
</tr>
<tr>
<td>Taxes payable</td>
<td>800,000</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>1,111,680</td>
</tr>
<tr>
<td>Current tax benefit ($2,000,000 × 40%)</td>
<td>800,000</td>
</tr>
<tr>
<td>Deferred tax benefit ($2,779,200 × 40%)</td>
<td>1,111,680</td>
</tr>
</tbody>
</table>

The amounts of interest expense and discount amortization are calculated by using the effective interest method. The effective interest rate is the nonconvertible borrowing rate at inception. The amortization of the debt discount causes annual reported interest expense (8 percent of the net carrying amount at the beginning of each annual period) to exceed the cash interest paid (2 percent of the principal amount of $100,000,000).

Because the issuer is entitled to tax deductions in each annual period that are based on the cash interest it pays during the period, it receives a tax benefit in each annual period equal to the cash interest paid times its tax rate ($2,000,000 × 40%). Further, the deferred tax liability is reduced in each period to reflect that portion of reported interest expense that results from the annual amortization of the debt discount, which is not deductible on the issuer's tax return. This is calculated as the amount of annual debt amortization multiplied by the issuer's effective tax rate.

6.7.4 Derecognition

6.7.4.1 General Considerations

<table>
<thead>
<tr>
<th><strong>ASC 470-20</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>55-77 Upon settlement of the notes, the fair value of the liability component immediately before extinguishment is measured first, and the difference between the fair value of the aggregate consideration remitted to the holder ($140,000,000) and the fair value of the liability component is attributed to the reacquisition of the equity component. The following illustrates how the fair value of the liability component might be calculated at settlement using a discount rate adjustment present value technique (an income approach). Depending on the terms of the instrument (for example, if the instrument contains prepayment features other than the embedded conversion option) and the availability of inputs to valuation techniques, it may be appropriate to determine the fair value of the liability component using an expected present value technique (an income approach), a valuation technique based on prices and other relevant information generated by market transactions involving comparable liabilities (a market approach), or both an income approach and a market approach.</td>
</tr>
</tbody>
</table>
### ASC 470-20 (continued)

**55-78** The fair value of the liability component (which has a remaining term of 5 years at the settlement date) can be estimated by calculating the present value of its cash flows using a discount rate of 7.5 percent, the market rate for similar notes that have no conversion rights, as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of the principal — $100,000,000 payable in 5 years</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Present value of interest — $2,000,000 payable annually in arrears for 5 years</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Consideration attributed to liability component</td>
<td>$23,956,000</td>
</tr>
<tr>
<td>Consideration attributed to equity component ($140,000,000 – $77,747,633)</td>
<td>$62,252,367</td>
</tr>
<tr>
<td>Consideration attributed to equity component ($140,000,000 – $77,747,633)</td>
<td>$62,252,367</td>
</tr>
</tbody>
</table>

Regardless of the form of the $140,000,000 consideration transferred at settlement, $77,747,633 would be attributed to the extinguishment of the liability component and $62,252,367 would be attributed to the reacquisition of the equity component. The carrying amount of the liability is $76,043,740 ($100,000,000 principal – $23,956,260 unamortized discount) at the December 31, 2011 settlement date, resulting in a $1,703,893 loss on extinguishment.

As illustrated in ASC 470-20-55-80 through 55-82, some of the accounting entries at settlement depend on the manner of settlement (i.e., cash, shares, or a combination of cash and shares). Other accounting entries, however, are the same irrespective of the manner of settlement. In each settlement alternative:

- The current net carrying amount of the liability component is derecognized (i.e., Dr: Debt $100,000,000; Cr: Debt discount $23,956,000).
- A debt extinguishment loss is recognized (i.e., Dr: Loss upon extinguishment $1,704,000). The debt extinguishment loss is calculated as the difference between (1) the current net carrying amount of the liability component ($76,044,000) and (2) the portion of the fair value of the consideration transferred to the holder (i.e., cash, equity shares, or both) that is allocable to the liability component (i.e., the fair value of that component immediately before settlement, $77,748,000).
- The carrying amount of the equity component is derecognized (i.e., Dr: APIC $62,252,000).
- The current carrying amount of the deferred tax liability related to the remaining unamortized debt discount is derecognized (Dr: Deferred tax liability $9,583,000) while making offsetting entries to the deferred tax benefit for the portion attributable to the debt extinguishment loss (i.e., $1,704,000 × 40%; Cr: $682,000) and APIC for the remainder ([$23,956,000 – $1,704,000] × 40%; Cr: $8,901,000).

Accordingly, these are the entries at settlement that do not depend on the form of consideration transferred at settlement:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>100,000,000</td>
</tr>
<tr>
<td>APIC — conversion option</td>
<td>62,252,000</td>
</tr>
<tr>
<td>Loss upon extinguishment</td>
<td>1,704,000</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>9,583,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>23,956,000</td>
</tr>
<tr>
<td>Deferred income tax benefit ($1,704,000 × 40%)</td>
<td>682,000</td>
</tr>
<tr>
<td>APIC ([$23,956,000 – $1,704,000] × 40%)</td>
<td>8,901,000</td>
</tr>
</tbody>
</table>
The remaining entry for an aggregate amount of $140 million (a credit) depends on the form of consideration transferred (i.e., cash, shares, or a combination thereof).

### 6.7.4.2 Settlement in a Combination of Cash and Shares

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-80</strong> At settlement, assume Entity A elects to transfer consideration to the holder in the form of $100,000,000 cash and 285,714 shares of common stock (with a fair value of $40,000,000). The $62,252,367 decrease to additional paid-in capital for the reacquisition of the conversion option, the $39,997,143 increase to additional paid-in capital from the issuance of common stock at conversion, and the $8,900,947 increase to additional paid-in capital to reverse the deferred tax liability relating to the unamortized debt discount at conversion, adjusted for the loss on extinguishment, are presented on a gross basis in this journal entry for illustrative purposes. Based on these assumptions, Entity A would make the following journal entry at settlement.</td>
</tr>
<tr>
<td>Debt</td>
</tr>
<tr>
<td>Additional paid-in capital — conversion option</td>
</tr>
<tr>
<td>Loss on extinguishment</td>
</tr>
<tr>
<td>Deferred tax liability</td>
</tr>
<tr>
<td>Debt discount</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Common stock at par</td>
</tr>
<tr>
<td>Additional paid-in capital — share issuance</td>
</tr>
<tr>
<td>Deferred income tax benefit ($1,704,000 × 40%)</td>
</tr>
<tr>
<td>Additional paid-in capital [($23,956,000 – $1,704,000) × 40%]</td>
</tr>
</tbody>
</table>

In the example in ASC 470-20-55-80, the issuer elected to settle by transferring $100 million of cash and $40 million worth of shares. Accordingly, it recognizes entries for the cash paid (Cr: Cash $100,000,000) and the shares issued. If the quoted market price of each share is $140, the issuer would transfer 285,714 shares ($40,000,000 ÷ $140). If the par value of each share is $0.01, the aggregate par value of those shares would be $2,857. In ASC 470-20-55-80, that number has been rounded to $3,000. The issuer allocates the amount recognized in equity between paid-in capital (Cr: Common stock at par $3,000) and APIC (Cr: APIC $39,997,000) on the basis of the aggregate par value of the shares. The other accounting entries are the same as those for the other manners of settlement (i.e., all cash or all shares).
6.7.4.3 Cash Settlement

**ASC 470-20**

55-81 Assume Entity A elects to transfer consideration to the holder in the form of $140,000,000 cash. Based on that assumption, Entity A would record the following journal entry at settlement:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital — conversion option</td>
<td>62,252,000</td>
</tr>
<tr>
<td>Loss on extinguishment</td>
<td>1,704,000</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>9,583,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>23,956,000</td>
</tr>
<tr>
<td>Cash</td>
<td>140,000,000</td>
</tr>
<tr>
<td>Deferred income tax benefit ($1,704,000 × 40%)</td>
<td>682,000</td>
</tr>
<tr>
<td>Additional paid-in capital [($23,956,000 – $1,704,000) × 40%]</td>
<td>8,901,000</td>
</tr>
</tbody>
</table>

In the example in ASC 470-20-55-81, the issuer elected to settle by transferring $140 million of cash. Accordingly, it records an entry for the cash paid (Cr: Cash $140,000,000). The other accounting entries are the same as those for the other manners of settlement (i.e., a combination of cash or shares, or all shares).

6.7.4.4 Share Settlement

**ASC 470-20**

55-82 Assume Entity A elects to transfer consideration to the holder in the form of 1 million shares of common stock (with a fair value of $140,000,000). Based on that assumption, Entity A would record the following journal entry at settlement:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital — conversion option</td>
<td>62,252,000</td>
</tr>
<tr>
<td>Loss on extinguishment</td>
<td>1,704,000</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>9,583,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>23,956,000</td>
</tr>
<tr>
<td>Common stock at par</td>
<td>10,000</td>
</tr>
<tr>
<td>Additional paid-in capital — share issuance</td>
<td>139,990,000</td>
</tr>
<tr>
<td>Deferred income tax benefit ($1,704,000 × 40%)</td>
<td>682,000</td>
</tr>
<tr>
<td>Additional paid-in capital [($23,956,000 – $1,704,000) × 40%]</td>
<td>8,901,000</td>
</tr>
</tbody>
</table>

In the example in ASC 470-20-55-82, the issuer elected to settle by transferring $140 million worth of shares. Accordingly, it recognizes entries for the shares issued. If the quoted market price of each share is $140, the issuer transfers 1 million shares ($140 million ÷ $140). If the par value of each share is $0.01, the aggregate par value of those shares is $10,000 (1,000,000 × $0.01). The issuer allocates the amount recognized in equity between paid-in capital (Cr: Common stock at par $10,000) and APIC (Cr: APIC $139,990,000) on the basis of the aggregate par value of the shares. The other accounting entries are the same as those for the other manners of settlement (i.e., combination of cash and shares or all cash).
Chapter 7 — Beneficial Conversion Features

7.1 Overview

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>05-7 Entities may issue convertible debt securities and convertible preferred stock with a beneficial conversion feature. Those instruments may be convertible into common stock at the lower of a conversion rate fixed at the commitment date or a fixed discount to the market price of the common stock at the date of conversion.</td>
</tr>
</tbody>
</table>

A BCF is an equity conversion feature embedded in a debt or equity instrument that is beneficial to the holder (investor) at the inception of the transaction. To recognize a BCF under ASC 470-20, an entity allocates the portion of the instrument's carrying amount that equals the BCF's intrinsic value to APIC upon the initial recognition of the instrument or, in the case of a contingent BCF, at the time it is triggered (see Section 7.5).

Changing Lanes

The FASB has tentatively decided to remove the separation model in ASC 470-20 for convertible instruments with a BCF. Instead, an entity would account for a convertible debt instrument wholly as debt (see Chapter 4) unless the instrument contains features that require bifurcation as a derivative under ASC 815 (see Section 2.3 and Appendix A). We expect the FASB to issue a final ASU in the third quarter of 2020. Companies should work with their auditors and accounting advisers to evaluate the potential impact as well as monitor developments and consider the need for disclosure. See Chapter 1 for additional details.

7.2 Scope

7.2.1 General Considerations

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-4 The guidance in the following paragraph and paragraph 470-20-25-6 applies to all of the following instruments if the instrument is not within the scope of the Cash Conversion Subsections:</td>
</tr>
<tr>
<td>a. Convertible securities with beneficial conversion features that must be settled in stock</td>
</tr>
<tr>
<td>b. Convertible securities with beneficial conversion features that give the issuer a choice of settling the obligation in either stock or cash</td>
</tr>
<tr>
<td>c. Instruments with beneficial conversion features that are convertible into multiple instruments, for example, a convertible preferred stock that is convertible into common stock and detachable warrants</td>
</tr>
<tr>
<td>d. Instruments with conversion features that are not beneficial at the commitment date (see paragraphs 470-20-30-9 through 30-12) but that become beneficial upon the occurrence of a future event, such as an initial public offering.</td>
</tr>
</tbody>
</table>
The BCF guidance in ASC 470-20 applies to the issuer's accounting for debt instruments that are convertible into its equity shares if (1) the conversion feature is beneficial to the holder (see Section 7.3 for a discussion of how to determine whether a conversion feature is beneficial) and (2) no scope exception is applicable. The guidance applies to both convertible debt and equity-classified convertible shares (e.g., convertible preferred stock); however, this Roadmap only addresses BCFs in convertible debt instruments.

Examples of instruments that may fall within the scope of the BCF guidance include:

- Debt instruments that are convertible into shares of the issuer’s common or preferred stock.
- Debt instruments that are convertible into a combination of debt instruments and detachable warrants on the issuer’s stock.
- Physically settled warrants that upon exercise will be settled in the issuer’s convertible debt securities.

For a discussion of the application of the BCF guidance to instruments with share-settled redemption features, see Sections 2.4 and 7.2.3 (below).

### 7.2.2 Embedded Derivatives

As discussed in Section 2.3, the requirements in ASC 470-20 for the accounting for a convertible debt instrument with an embedded equity conversion feature (e.g., the BCF guidance) do not apply if the feature must be bifurcated and accounted for as a derivative instrument under ASC 815. Therefore, an issuer needs to determine whether ASC 815-15 requires bifurcation of the conversion feature before it can conclude whether the BCF guidance in ASC 470-20 applies to the feature. If a feature other than the BCF (e.g., a call or put option) must be bifurcated from the convertible debt instrument, however, the instrument is not exempt from the BCF guidance in ASC 470-20.

### 7.2.3 Share-Settled Redemption Features

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-8 If a convertible instrument has a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date, the convertible instrument shall be considered stock-settled debt and the contingent beneficial conversion option provisions of this Subtopic would not apply when those resets subsequently occur. However, the guidance in paragraph 470-20-25-5 applies to the initial recognition of such a convertible instrument, including any initial active beneficial conversion feature. Example 4 (see paragraph 470-20-55-18) illustrates application of the guidance in this paragraph.</td>
</tr>
<tr>
<td>25-9 For guidance on a contingent conversion feature that will reduce (reset) the conversion price if the fair value of the underlying stock declines after the commitment date to or below a specified price, see paragraph 470-20-35-4.</td>
</tr>
</tbody>
</table>

**Example 4: Stock-Settled Debt**

55-18 This Example illustrates the guidance in paragraph 470-20-25-8.

55-19 If the conversion price was described as $1 million divided by the market price of the common stock on the date of the conversion, that is, resetting at the date of conversion, the holder is guaranteed to receive $1 million in value upon conversion and, therefore, there is no beneficial conversion option and the convertible instrument would be considered stock-settled debt. However, if the conversion price does not fully reset (for example, resets on specified dates before maturity), the reset represents a contingent beneficial conversion feature subject to this Subtopic.
In some convertible instruments, the conversion terms continuously reset to provide the holder with a fixed value (i.e., the number of shares delivered varies to achieve a constant value) or a value that is indexed to a variable other than the issuer's stock price. For example, the conversion terms may require the issuer to deliver a variable number of shares that is calculated by dividing the instrument's principal amount by the current share price (or a fixed percentage thereof) on the conversion date so that the aggregate fair value of the shares delivered upon conversion equals or approximates a fixed monetary amount.

In accordance with ASC 815-15, an issuer should evaluate a feature that is settled in a variable number of shares equal to a fixed monetary amount or a monetary amount that is indexed to an unrelated underlying to determine whether it must be bifurcated as an embedded put, call, redemption, or indexation feature and accounted for as a derivative instrument under ASC 815 (see Section 2.4). An entity should also evaluate any variable share-settled instrument under ASC 480-10-25-14 to determine whether it must be classified as a liability under ASC 480.

If a convertible instrument is in the legal form of a share and the obligation to issue a variable number of equity shares is unconditional (i.e., conversion is certain to occur) and based solely or predominantly on a fixed monetary amount known at inception, the instrument must be accounted for as a liability under ASC 480-10-25-14. Similarly, if a convertible instrument is in the legal form of a share and the instrument embodies multiple obligations that in combination represent an unconditional obligation to repurchase the shares by either transferring assets or issuing a variable number of shares equal to a fixed value, the instrument is required to be classified as a liability under ASC 480-10 (see Deloitte's A Roadmap to Distinguishing Liabilities From Equity). If a convertible instrument is in the legal form of a share and is not required to be classified as a liability under ASC 480-10 because the obligation is conditional (i.e., conversion or settlement is not certain to occur), the instrument generally does not have to be classified as a liability under U.S. GAAP.

The guidance in ASC 470-20-25-8 suggests that ASC 470-20-25-5, which addresses the recognition of a BCF at issuance, applies to initial recognition of the convertible instrument for which conversion would result in the delivery of shares worth a fixed value; however, ASC 470-20-55-19 states that there is no BCF in such an instrument. We believe that in a manner consistent with ASC 470-20-55-19, the BCF guidance does not apply to a conversion feature that economically represents a share-settled redemption feature. That is, we believe that the BCF guidance applies only to a “true” conversion feature that has a value that changes with the underlying share price.

EITF Issue 98-5 originally included three illustrative examples of convertible instruments whose conversion price was a function of the current or average stock price on the conversion date (Cases 1(c), 1(d), and 5). Each instrument had a face amount of $1 million and a commitment-date stock price of $50 and was convertible on the date of issuance. The conversion prices and associated conversion values (i.e., the monetary values of the shares received upon conversion) in the three examples are indicated in the table below.
The guidance in EITF Issue 98-5 on each of these examples suggested that an initial BCF should be recognized since conversion was assumed to occur at a beneficial conversion price (i.e., $40, $40, and $36, respectively) compared with the commitment-date stock price ($50). However, EITF Issue 08-4 removed these examples. Cases 1(c) and 5 were removed because “the instruments described in those examples are within the scope of [ASC 480-10],” and Case 1(d) was removed because “the instruments described in that example require an assessment of accounting literature that was issued subsequent to [EITF Issue 98-5].” Accordingly, we believe that share-settled redemption features that specify fixed or approximately fixed values such as those illustrated in these examples, whether on the final maturity date or upon an earlier conversion, should not be evaluated by using the BCF guidance.

In addition to a share-settled redemption component with a fixed monetary amount ($1.25 million), the instrument in Case 1(d) contains a “true” equity conversion option component with an effective conversion price of $50 — that is, the conversion value varies with changes in the issuer’s stock price if the conversion-date stock price exceeds $50. Although the BCF guidance does not apply to the share-settled redemption component of the instrument, the issuer should consider whether there is a BCF attributable to the “true” conversion component (unless the feature must be bifurcated under ASC 815-15 or is within the scope of the CCF guidance in ASC 470-20). (Note that this Roadmap does not address whether an entity should analyze the two components as a single compound embedded feature or as two separate embedded features in evaluating whether the instrument contains any features that require bifurcation as a derivative instrument under ASC 815. When the EITF decided to delete Case 1(d) of EITF Issue 98-5, it observed that there was diversity in practice on this issue.)

### 7.2.4 Fair Value Option

In accordance with ASC 825-10-15-5(f), the fair value option in ASC 825-10 is not available for “financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders’ equity.” Under ASC 470-20, the issuer of a convertible debt instrument that is within the scope of the BCF guidance and contains a noncontingent BCF must separate the instrument into liability and equity components at issuance. Accordingly, the issuer is not permitted to elect the fair value option in ASC 825-10 — or, by analogy, in ASC 815-15 — for such an instrument (see Section 2.5 for further discussion).
ASC 825-10 does not explicitly state whether an issuer may elect the fair value option for a debt instrument that contains a contingent BCF and for which no portion of the carrying amount would be classified in shareholders’ equity unless or until the contingent BCF is triggered. However, because no part of the instrument is classified in shareholders’ equity at issuance (see Section 7.5), the issuer is not precluded from electing the fair value option in ASC 825-10. If the contingency is triggered after election of this option, the instrument would continue to be subject to fair value measurement under ASC 825-10 since the fair value option is irrevocable and is applied to the entire instrument. In this circumstance, ASC 825-10 effectively overrides the guidance on contingent BCFs in ASC 470-20 once the fair value option has been elected. Accordingly, an instrument that the issuer elected to measure at fair value under the fair value option in ASC 825-10 is outside the scope of the contingent BCF guidance in ASC 470-20.

7.2.5 Cash Conversion Features

The BCF guidance does not apply to a conversion feature that causes a convertible debt instrument to be separated into liability and equity components under the CCF guidance in ASC 470-20 (see Chapter 6). Accordingly, an issuer should evaluate whether the CCF guidance applies before potentially considering the BCF guidance.

7.2.6 The SEC’s Requirements Related to Temporary Equity

As discussed in Section 2.6, an issuer that is an SEC registrant should consider whether the SEC’s guidance on redeemable securities in ASC 480-10-S99-3A applies to all or a portion of the equity-classified components of convertible debt instruments that are separated into liability and equity components under the BCF guidance in ASC 470-20.

While the guidance on temporary equity applies to equity-classified redeemable convertible stock with a BCF, such guidance does not apply if a convertible debt instrument with a BCF is not currently redeemable even if it may become redeemable in the future. As indicated in ASC 480-10-S99(12), for convertible debt instruments with a BCF, the amount of temporary equity is limited to the excess (if any) of “(1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion . . . over (2) the carrying amount of the liability-classified component of the convertible debt instrument” both at initial measurement and on subsequent balance sheet dates.

Connecting the Dots

For further discussion of the application of the SEC’s guidance on temporary equity, see Chapter 9 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity.

7.2.7 Liability-ClassifiedConvertible Shares

The BCF guidance in ASC 470-20 typically does not apply to convertible shares of stock (e.g., convertible preferred shares) that are classified as liabilities under ASC 480-10.

To be classified as a liability under ASC 480-10-25-4, a convertible share must meet the definition of a mandatorily redeemable financial instrument in ASC 480-10-20; that is, redemption in cash or other assets would need to be certain upon conversion. If such a conversion feature is not required to be bifurcated as a derivative under ASC 815-15, the instrument would be within the scope of the CCF guidance in ASC 470-20 because it requires or permits settlement in cash or other assets upon conversion. Consequently, it would be exempt from the scope of the BCF guidance in ASC 470-20.
Further, to be classified as a liability under ASC 480-10-25-14, a convertible share must contain an unconditional obligation to deliver a variable number of shares that is predominantly based on (1) a fixed monetary amount known at inception, (2) variations in something other than the fair value of the issuer’s equity shares, or (3) variations that are inversely related to changes in the fair value of the issuer’s equity shares. Economically, such features do not represent conversion features. Instead, the issuer is using its own equity shares as currency to settle the monetary amount of the obligation that does not vary in the same manner as changes in the fair value of the issuer’s equity shares. As noted in Section 7.2.3, the BCF guidance does not apply to stock-settled instruments regardless of whether they are in the legal form of equity or debt.

Connecting the Dots

For further discussion of the application of ASC 480-10, see Deloitte’s A Roadmap to Distinguishing Liabilities From Equity.

7.2.8 Grandfathered Guidance

In accordance with EITF Issue 00-27, the BCF guidance in ASC 470-20 applies to instruments issued after November 16, 2000 (the date the EITF reached a consensus on Issue 00-27), unless a commitment date (as originally defined in EITF Issue 98-5) had occurred before that date. As indicated in ASC 105-10-70-2, for instruments issued before November 16, 2000, legacy BCF accounting guidance remains authoritative even though it is not in the Codification. Such guidance includes the SEC Staff Observer Announcement in EITF Topic D-60 for instruments issued before May 20, 1999, and EITF Issue 98-5 for instruments issued between May 20, 1999, and November 16, 2000. Although the legacy BCF guidance includes a requirement to recognize BCFs, some of the detailed application guidance differs from that in ASC 470-20 (e.g., EITF Topic D-60 and ASC 470-20 generally require different periods of amortization for BCFs associated with a convertible debt security).

7.3 Initial Accounting

7.3.1 Recognition

<table>
<thead>
<tr>
<th>ASC 470-20 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beneficial Conversion Feature</td>
</tr>
<tr>
<td>A nondetachable conversion feature that is in the money at the commitment date.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-5 An embedded beneficial conversion feature present in a convertible instrument shall be recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. Paragraph 470-20-30-4 provides guidance on measuring intrinsic value that applies to both the determination of whether an embedded conversion feature is beneficial and the allocation of proceeds.</td>
</tr>
</tbody>
</table>

An embedded conversion feature is considered beneficial (i.e., a BCF exists) if it is in-the-money on the basis of a comparison between (1) the initial fair value of the shares of the issuer’s stock into which the instrument is convertible and (2) the instrument’s effective conversion price (see Section 7.3.2).
The timing of the recognition of a BCF depends on whether it is contingent:

- A noncontingent (or initial) BCF either (1) is immediately exercisable or (2) will become exercisable if there is no change in circumstances other than the passage of time. A noncontingent BCF is accounted for separately from the convertible debt instrument in which it is embedded; at issuance, the issuer allocates to APIC a portion of the proceeds received for the convertible debt instrument equal to the BCF's intrinsic value (see Section 7.3.2). The resulting discount (or reduced premium) on the convertible debt instrument is amortized as interest expense (see Section 7.4.1).

- A contingent BCF is triggered if an uncertain future event or circumstance occurs. There are two types of contingent BCFs: (1) those that are only contingently exercisable (e.g., a conversion feature that can only be exercised if an IPO occurs) and (2) those that are associated with contingently adjustable conversion ratios (e.g., a conversion ratio that resets upon a change of control so that it becomes beneficial or more beneficial). Contingent BCFs are not recognized unless they are triggered (see Section 7.5).

We believe that if a BCF becomes exercisable upon the occurrence of an event that is within the holder’s control (i.e., the holder has the unilateral ability to cause the conversion feature to become exercisable), the BCF would be considered noncontingent. If an instrument contains two contingently exercisable BCFs that are mutually exclusive of one another (e.g., one conversion feature is contingent on a merger’s occurring by a certain date and the other conversion feature is contingent on a merger’s not occurring by that date), we believe that the convertible instrument contains a noncontingent BCF because a merger would not occur upon only the passage of time. The issuer should treat the merger’s effect on the BCF (e.g., to increase, reduce, or eliminate the noncontingent BCF) like a contingent BCF and not recognize it before the merger occurs.

**Example 7-1**

**Convertible Debt Instrument With a Noncontingent BCF**

A convertible debt instrument is issued at par for cash proceeds of $1 million. The instrument contains a noncontingent BCF with an intrinsic value of $200,000 as of the commitment date.

The journal entry on the date of issuance is as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>200,000</td>
</tr>
<tr>
<td>Debt</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>200,000</td>
</tr>
</tbody>
</table>
7.3.2 Measurement

7.3.2.1 Intrinsic Value

**ASC 470-20**

**25-5** An embedded beneficial conversion feature present in a convertible instrument shall be recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. Paragraph 470-20-30-4 provides guidance on measuring intrinsic value that applies to both the determination of whether an embedded conversion feature is beneficial and the allocation of proceeds.

**30-3** An embedded beneficial conversion feature recognized separately under paragraph 470-20-25-5 shall be measured initially at its intrinsic value.

**30-4** The following guidance on measurement of the intrinsic value of an embedded conversion feature applies for purposes of both determining whether the feature is beneficial and allocating proceeds under paragraph 470-20-25-5, if applicable.

**30-6** Intrinsic value shall be calculated at the commitment date (see paragraphs 470-20-30-9 through 30-12) as the difference between the conversion price (see paragraph 470-20-30-5) and the fair value of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible.

**30-8** If the intrinsic value of the beneficial conversion feature is greater than the proceeds allocated to the convertible instrument, the amount of the discount assigned to the beneficial conversion feature shall be limited to the amount of the proceeds allocated to the convertible instrument.

To determine whether a BCF exists in a convertible debt instrument and, if so, to measure it, an issuer should calculate the feature's intrinsic value, if any. The calculation of the intrinsic value depends on the following:

- The fair value of the shares of stock into which the instrument is convertible on the applicable measurement date (generally the commitment date; see Section 7.3.2.3.1).
- The instrument's effective conversion price (see Section 7.3.2.2), which depends on the amount of proceeds allocated to the instrument and the number of instruments issued.

The issuer computes the intrinsic value by multiplying (1) any excess of the initial fair value of each share of common stock or other securities into which the instrument is convertible \( S_0 \) over the effective conversion price \( X_0 \) (see Section 7.3.2.2) by (2) the number of shares into which the instrument is convertible \( n_0 \); all values are determined as of the applicable measurement date (typically the commitment date; see Section 7.3.2.3.1). Algebraically, this can be expressed as follows:

\[
\text{Intrinsic value} = \left( \max \left[ S_0 \times X_0 \right] - X_0 \right) \times n_0
\]

Because the calculation of the effective conversion price \( X_0 \) depends on the number of shares to be issued upon conversion \( n_0 \) and the amount of proceeds \( P_0 \) allocated to the instrument (i.e., \( X_0 = P_0 / n_0 \)), an alternative method of determining the intrinsic value is to calculate the excess, if any, of (1) the initial fair value of the instruments into which the instrument is convertible (i.e., \( S_0 \times n_0 \)) over (2) the amount of proceeds \( P_0 \) allocated to the instrument. Algebraically, this can be expressed as follows:

\[
\text{Intrinsic value} = \max \left( \left( S_0 \times n_0 \right) - P_0 \right), 0
\]
Example 7-2

**Calculation of Intrinsic Value**

A convertible debt instrument whose terms permit the holder to convert it into the issuer’s equity shares after five years is issued for proceeds of $1 million, which equals its carrying amount. The terms specify a fixed conversion price of $100 per share. Accordingly, the holder would receive 10,000 shares upon conversion ($1,000,000 ÷ $100). The commitment-date stock price is $105. Therefore, the intrinsic value per share is $5 (calculated as the excess of the commitment-date stock price of $105 over the effective conversion price of $100). The amount of the BCF equals the aggregate intrinsic value associated with the conversion feature, which is $50,000 ($5 × 10,000 shares).

The journal entry on the date of issuance is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>50,000</td>
</tr>
<tr>
<td>Debt</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>50,000</td>
</tr>
</tbody>
</table>

If this example was modified so that the commitment-date stock price was $95 instead of $105, the intrinsic value would be zero and no BCF would be present. A BCF exists only if the conversion feature is beneficial to the holder on the basis of the commitment-date stock price.

If the intrinsic value exceeds the proceeds allocated to the convertible debt instrument, the amount assigned to the BCF is limited by the amount allocated to the convertible debt instrument (i.e., the amount of BCF recognized in APIC cannot exceed the amount of proceeds allocated to the convertible debt instrument). In this circumstance, the issuer should disclose (1) the excess of the fair value of the instrument that the holder would receive at conversion over the proceeds received and (2) the period over which the discount is amortized (see ASC 505-10-50-8).

Example 7-3

**Calculation of Intrinsic Value When It Exceeds Proceeds From Issuance**

Entity A issues a convertible debt instrument that contains a BCF for cash proceeds of $13 million. The intrinsic value of the BCF is $15 million. Since the intrinsic value is greater than the proceeds allocated to the convertible instrument, the amount of the debt discount is limited to $13 million.

The journal entry at the date of issuance is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>13,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>13,000,000</td>
</tr>
<tr>
<td>Debt</td>
<td></td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>13,000,000</td>
</tr>
</tbody>
</table>

Although the intrinsic value calculation incorporates the fair value of the stock into which the instrument is convertible, the conversion feature’s intrinsic value differs from its fair value. For instance, the intrinsic value excludes any option time value associated with the feature. When developing the BCF guidance that was subsequently codified in ASC 470-20, the EITF considered adopting a fair value measurement approach for BCFs but ultimately rejected it because of practical issues in determining fair value. Further, as discussed in EITF Issue 00-27, Issue Summary 1 (November 2, 2000), some noted that measuring the BCF at fair value would be inconsistent with the guidance that applies to traditional convertible debt, which prohibits separate accounting for an out-of-the-money conversion option (see Chapter 4).
7.3.2.1.1 Illustrations — BCF Calculations

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 7: Beneficial Conversion Features or Contingently Adjustable Conversion Ratios</strong></td>
</tr>
</tbody>
</table>
| 55-28 The following Cases illustrate the guidance for beneficial conversion features or contingently adjustable conversion ratios for convertible securities:
| a. Instrument is convertible at inception, fixed dollar conversion terms (Base Case) (Case A).
| b. Instrument is not convertible at inception, fixed dollar conversion terms (Base Case) (Case B). . . . |

**Case A: Instrument Is Convertible at Inception, Fixed Dollar Conversion Terms (Base Case)**

55-29 This Case illustrates the guidance in paragraph 470-20-35-7.

55-30 This Case has the following assumptions:
| a. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance |
| b. Convertible at date of issuance |
| c. Convertible at $40 per share |
| d. Fair value of common stock at commitment date equals $50 per share |

55-31 The calculation is as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value at commitment date</td>
<td>$50</td>
</tr>
<tr>
<td>Conversion price (stated and will not change)</td>
<td>$40</td>
</tr>
<tr>
<td>Intrinsic value of beneficial conversion feature</td>
<td>$250,000 (a)</td>
</tr>
</tbody>
</table>

| Amount to record at date of issuance | $250,000 |

(a) Convertible into 25,000 shares (1,000,000 ÷ 40) with an intrinsic value of $10 (50 – 40) or overall: (1,000,000 ÷ 40) × (50 – 40).

55-32 The beneficial conversion feature is calculated at its intrinsic value (that is, the difference between the conversion price and the fair value of the common stock into which the debt is convertible, multiplied by the number of shares into which the debt is convertible) at the commitment date. A portion of the proceeds from issuance of the convertible debt, equal to the intrinsic value, is then allocated to additional paid-in capital. Because the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

55-33 Entry at date of issuance.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>250,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>250,000</td>
</tr>
</tbody>
</table>

**Case B: Instrument Is Not Convertible at Inception, Fixed Dollar Conversion Terms (Base Case)**

55-34 This Case illustrates the guidance in paragraph 470-20-35-7.
This Case has the following assumptions:

a. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance
b. Convertible in one year
c. Convertible at $40 per share
d. Fair value of common stock at commitment date equals $50 per share.

The calculation is as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value at commitment date</td>
<td>$ 50</td>
</tr>
<tr>
<td>Conversion price (stated and will not change)</td>
<td>$ 40</td>
</tr>
<tr>
<td>Intrinsic value of beneficial conversion feature</td>
<td>$ 250,000</td>
</tr>
<tr>
<td>Amount to record over period to stated redemption</td>
<td>$ 250,000</td>
</tr>
</tbody>
</table>

\[ (1,000,000 \div 40) \times (50 - 40) \]

The beneficial conversion feature is calculated at its intrinsic value at the commitment date (that is, the difference between the conversion price and the fair value of the common stock into which the debt is convertible, multiplied by the number of shares into which the debt is convertible). A portion of the proceeds from issuance of the convertible debt, equal to the intrinsic value, is then allocated to additional paid-in capital. Because the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

Entry at date of issuance.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>250,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$ 1,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>250,000</td>
</tr>
</tbody>
</table>

### 7.3.2.2 Conversion Price

#### 7.3.2.2.1 Effective Conversion Price

The effective conversion price based on the proceeds received for or allocated to the convertible instrument shall be used to compute the intrinsic value, if any, of the embedded conversion option. Specifically, an issuer shall do all of the following:

a. First, allocate the proceeds received in a financing transaction that includes a convertible instrument to the convertible instrument and any other detachable instruments included in the exchange (such as detachable warrants) on a relative fair value basis.

b. Second, apply the guidance beginning in paragraph 470-20-25-4 to the amount allocated to the convertible instrument.

c. Third, calculate an effective conversion price and use that effective conversion price to measure the intrinsic value, if any, of the embedded conversion option.

Example 2 (see paragraph 470-20-55-10) illustrates the application of this guidance.
As discussed in Section 7.3.2.1, the intrinsic value of a BCF is calculated as the product of (1) the excess, if any, of the fair value of the common stock or other securities into which the instrument is convertible over the effective conversion price and (2) the number of shares into which the security is convertible.

The initial effective conversion price \(X_0\) is the ratio between the total proceeds allocated to the convertible instrument \(P_0\) and the number of securities into which it is convertible \(n_0\), determined as of the measurement date (generally the commitment date for the instrument; see Section 7.3.2.3.1). Algebraically, this can be expressed as follows:

\[
X_0 = \frac{P_0}{n_0}
\]

Often, the effective conversion price differs from the stated conversion price (i.e., the conversion price specified in the instrument’s terms, which is the ratio between the principal amount of the convertible debt instrument and the number of securities into which it is convertible) because the instrument was issued at an amount different from its principal amount (i.e., at a discount or premium) or was issued together with other detachable financial instruments. The carrying amount used to compute the effective conversion price reflects any initial discount or premium on the debt and excludes proceeds allocated to any freestanding financial instruments (e.g., detachable warrants) that were issued together with the convertible instrument (see Sections 3.4 and 3.5).

In the determination of the effective conversion price, the carrying amount of the convertible debt instrument (1) is not adjusted for issuance costs (see Section 7.3.2.2.3) and (2) includes the amount attributable to any embedded derivatives other than the conversion feature that must be separated under ASC 815-15 (see Section 7.3.2.2.4). Although ASC 470-20-30-5(a) suggests that a relative fair value method applies in the allocation of the proceeds among multiple units of account, this method is not always appropriate (see Section 3.5.2).

**Example 7-4**

**Calculation of Effective Conversion Price**

Entity A issues a convertible debt instrument along with detachable warrants for total gross proceeds of $1 million (which equals the principal amount of the convertible debt instrument) and determines that the detachable warrants are freestanding financial instruments that qualify for equity classification. Therefore, in accordance with ASC 470-20-30-1 and 30-2, A allocates the total proceeds to the convertible debt and the detachable warrants on a relative fair value basis (see Section 3.5.2).

After the allocation of proceeds to the detachable warrants, the convertible debt instrument has a carrying amount of $950,000. Per the terms of the instrument, holders can convert the debt into 10,000 common shares of A at any time. The stated conversion price is $100 per share, which also represents the market price of A’s shares on the commitment date.

To determine whether the convertible debt instrument contains a BCF, A calculates the effective conversion price by dividing the carrying amount of the convertible debt instrument before any adjustment for issuance costs ($950,000) by the number of shares into which the instrument can be converted (10,000). Entity A determines that the effective conversion price is $95, which is less than the market price of the underlying shares on the commitment date. Thus, the conversion option is in-the-money and a BCF exists. Entity A calculates the intrinsic value of the BCF to be $50,000 ([($100 – $95] \times 10,000).
Example 7-4 (continued)

The journal entry on the date of issuance is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>$100,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Detachable warrants</td>
<td>$50,000</td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

7.3.2.2.1.1 Illustration — Whether an Embedded Conversion Option Is Beneficial to the Holder

ASC 470-20

Example 2: Evaluating Whether an Embedded Conversion Option Is Beneficial to Holder

55-10 This Example illustrates the guidance in paragraph 470-20-30-5.

55-11 Assume Entity A issues for $1 million convertible debt with a par amount of $1 million and 100,000 detached warrants. The convertible debt is convertible at a conversion price of $10 per share (holder would receive 100,000 shares of Entity A common stock upon conversion). The fair value of Entity A’s stock at the commitment date is $10. Further, assume that the ratio of the relative fair values of the convertible debt and the detached warrants is 75 to 25. After allocating 25 percent or $250,000 of the proceeds to the detached warrants (based on relative fair values), the convertible debt is recorded on the balance sheet at $750,000 (net of the discount that arises from the allocation of proceeds to the warrants), and the detached warrants are recorded in paid-in capital in the balance sheet at $250,000.

55-12 Entity A must evaluate whether the embedded conversion option within the debt instrument is beneficial (has intrinsic value) to the holder. The effective conversion price (that is, the allocated proceeds divided by the number of shares to be received on conversion) based on the proceeds of $750,000 allocated to the convertible debt is $7.50 ($750,000 ÷ 100,000 shares). The intrinsic value of the conversion option therefore is $250,000 [(100,000 shares) × ($10.00 – $7.50)] and is recognized as a reduction to the carrying amount of the convertible debt and an addition to paid-in capital. The total debt discount immediately after the initial accounting is performed is $500,000 ($250,000 from the allocation of proceeds to the warrants and an additional $250,000 from the measurement of the intrinsic value of the conversion option). The same answer would result if the debt had been issued without detachable warrants for $750,000 in proceeds.

The guidance in ASC 470-20-55-12 implies that Entity A made the following accounting entry at issuance:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>$500,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Equity — detachable warrants</td>
<td>$250,000</td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

An inherent assumption in ASC 470-20-55-11 is that the detachable warrants qualify as equity. If such warrants were required to be classified as liabilities and subsequently accounted for at fair value, with changes in fair value recognized in earnings under ASC 480-10 or ASC 815-40, a relative fair value approach would not be appropriate (see Section 3.5.2).
7.3.2.2.2 Most Favorable Conversion Price

**ASC 470-20**

**30-7** The most favorable conversion price that would be in effect at the conversion date, assuming there are no changes to the current circumstances except for the passage of time, shall be used to measure the intrinsic value of an embedded conversion option. Example 3 (see paragraph 470-20-55-13) illustrates the application of this guidance.

**30-15** If an instrument incorporates a multiple-step discount, the computation of the intrinsic value shall use the conversion terms that are most beneficial to the investor. Example 10 (see paragraph 470-20-55-69) illustrates the application of this paragraph.

If the contractual terms of a convertible debt instrument specify different conversion prices on different dates or in different circumstances, the intrinsic value is measured on the basis of the most beneficial (favorable) conversion price available to the holder provided that there will be no change in current facts and circumstances except for the passage of time. For example, the intrinsic value of a convertible debt instrument with a conversion price that involves a multiple-step discount to the issuer's commitment-date stock price is calculated on the basis of the most favorable discount available to the holder over the convertible instrument's life.

**Example 7-5**

**Conversion Price Declines With the Passage of Time**

A convertible debt instrument whose terms permit the holder to convert it into the issuer's common shares at any time is issued for proceeds of $1 million, which equals its carrying amount. The terms specify a conversion price of $120 in year 1, $110 in year 2, and $100 in year 3. The commitment-date stock price is $105. If there are no changes in circumstances except for the passage of time, the most favorable conversion price will be $100. Therefore, the intrinsic value of the conversion feature is calculated on the basis of an effective conversion price of $100 per share. The amount of the BCF is $50,000 (calculated as \([105 - 100] \times \frac{1,000,000}{100}\)).

**Example 7-6**

**Instrument With Multiple-Step Discount**

A convertible debt instrument that can be converted into the issuer's common shares at any time is issued for proceeds of $1 million, which equals its carrying amount. As specified in the instrument's terms, the conversion price is at a 10 percent discount to the commitment-date stock price in year 1 and a 20 percent discount to the commitment-date stock price in year 2. The stock price on the commitment-date is $100. Provided that there are no changes in circumstances except for the passage of time, the most favorable conversion price is an effective conversion price of $80 ($100 \times (100\% - 20\%)) The amount of the BCF is $250,000 (calculated as \([100 - 80] \times \frac{1,000,000}{80}\)).

When the contractual terms of a convertible instrument specify potential adjustments to the conversion terms that are based on the occurrence of specified future events or circumstances (e.g., the conversion price depends on whether an IPO occurs), the convertible debt instrument may contain both an initial BCF (also known as a “basic,” “active,” or “noncontingent BCF”) and one or more contingent BCFs. The intrinsic value of the initial BCF is measured on the basis of the most favorable conversion price that would be available to the holder on the conversion date if there were no changes in circumstances except for the passage of time (e.g., if the conversion price is adjusted on the basis of the amount of the issuer's earnings, the initial intrinsic value is determined under the assumption that the issuer will not generate any earnings after the instrument's commitment date). If potential changes to the conversion terms are contingent on future events or circumstances, the feature is analyzed as a contingent BCF (see Section 7.5).
Chapter 7 — Beneficial Conversion Features

Note that a conversion price adjustment provision often causes a conversion feature to be considered not indexed to the entity’s own equity shares (see Chapter 4 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity). The issuer should evaluate whether such a provision results in a requirement to bifurcate the conversion feature from its host contract under ASC 815-15 (see Section 2.3 and Appendix A). Further, if the conversion price adjustment is designed so that the monetary value the holder will receive upon conversion is fixed or approximately fixed, the conversion feature should be analyzed as a share-settled redemption feature (see Sections 2.4 and 7.2.3).

7.3.2.2.2.1 Illustration — Conversion Price Contingent on IPO

**Example 3: Conversion Price to Be Used to Measure Intrinsic Value**

55-13 This Example illustrates the guidance in paragraph 470-20-30-7.

55-14 Assume Entity A, a private entity, issues for $1 million a convertible instrument that is convertible 4 years after issuance at a conversion price of $10 per share (fair value of the stock is $10 at the commitment date). The instrument also contains a provision that the conversion price adjusts from $10 to $7 per share if Entity A does not have an initial public offering with a per-share price of $13 or more within 3 years. Entity B, a private entity, issues for $1 million a convertible instrument that is convertible 4 years after issuance at a conversion price of $7 per share (fair value of the stock is $10 at the commitment date). The instrument also contains a provision that the conversion price adjusts from $7 to $10 per share if Entity B successfully completes an initial public offering for a per-share price of $13 or more within 3 years.

55-15 The active conversion price for both Entity A and Entity B is $7, which is the conversion option price that would apply if there were no change in circumstances after the issuance date other than the passage of time. The intrinsic value of the conversion option of $428,571 \([($1 \text{ million} \div $7) \times ($10 – $7)]\) should be recognized at the issuance date of the convertible instrument. If an event occurs that triggers a decrease in the number of shares to the holder upon conversion (the initial public offering in this Example), the intrinsic value of the adjusted conversion option should be recomputed using the commitment-date fair value of the underlying stock and the proceeds received for or allocated to the convertible instrument in the initial accounting.

The guidance in ASC 470-20-55-14 and 55-15 implies that if the convertible instrument was issued in the form of debt, Entity A would have made the following entry at issuance:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>428,571</td>
</tr>
<tr>
<td>Debt</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>428,571</td>
</tr>
</tbody>
</table>

An unstated assumption in Example 3 is that the conversion feature is not required to be bifurcated as a derivative instrument under ASC 815-15-25-1 since that would have caused the instrument to fall outside the scope of the BCF guidance in ASC 470-20. While the example contains a conversion price adjustment that is contingent on the occurrence or nonoccurrence of an IPO, such occurrence or nonoccurrence is not an input in the pricing of a fixed-for-fixed forward or option on the issuer’s equity shares (see Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity), and therefore the conversion feature is not indexed to the entity’s own equity before the occurrence of an IPO. Accordingly, it does not qualify as equity under ASC 815-40 and would not qualify under the scope exception from derivative accounting in ASC 815-10-15-74(a) for contracts that are both indexed to the issuer’s own stock and classified in stockholders’ equity. However, although the feature does not qualify as equity, it would not require bifurcation as a derivative instrument under ASC 815-15 if
any of the criteria in ASC 815-15-25-1 were not met (e.g., the feature may not meet the net settlement characteristic in the definition of a derivative in ASC 815-10-15-83 if it involves gross physical settlement in private-company stock, such as in the example above).

Example 3 in ASC 470-20-55-13 also contains an illustration of the application of the contingent BCF guidance in ASC 470-20 (see Section 7.5).

### 7.3.2.2.2 Illustration — Conversion Price That Adjusts on the Basis of Outstanding Shares if No IPO Occurs

Convertible debt instruments sometimes have a conversion option with a stated conversion price that adjusts to a more favorable price from the perspective of the investor if the issuing entity does not complete an IPO before a specified date by giving holders an additional number of shares equal to a fixed percentage of the total shares outstanding as of a specified future date. In this circumstance, the issuing entity should calculate the most favorable conversion price by assuming that no changes in current circumstances have occurred (i.e., that no IPO will occur and that there will be no change in the number of shares outstanding) except for the passage of time.

**Example 7-7**

**Convertible Debt Instrument With Conversion Price Reset if an IPO Does Not Occur**

On January 1, 20X1, Company ABC issues at par $1 million of 7.5 percent senior secured convertible notes with the following terms:

- The notes mature at par on January 1, 20X5.
- The notes are not redeemable or callable before maturity.
- Holders of the notes can convert them at any time into common shares of the company.
- The initial conversion price is $100, which is the fair value of the common shares as of the issuance date.
- Company ABC has 100,000 shares outstanding as of the issuance date.
- If ABC does not complete an IPO within two years of issuance, the conversion price will be adjusted to give the holders, upon conversion, an additional number of shares equal to 2 percent of outstanding shares as of January 1, 20X3 (the “IPO adjustment provision”).

Assume that ABC has determined that the conversion option embedded in the notes is not a derivative instrument under ASC 815 because it does not permit net settlement and therefore does not need to be bifurcated. Further assume that the convertible debt is not subject to the CCF guidance in ASC 470-20 and there were no transaction costs.

Company ABC is considering whether it needs to record a BCF upon issuing the notes. Even though the initial conversion price of $100 equals the fair value of the common shares on the issuance date, that is not the most favorable conversion price that would be in effect on the conversion date if there were no changes to the current circumstances except for the passage of time, because under the IPO adjustment provision, a favorable adjustment to the conversion terms is required after two years unless a contingent event (i.e., an IPO) occurs. Accordingly, ABC should not use the initial conversion price of $100 in measuring the intrinsic value of the conversion feature.

When determining the most favorable conversion price under ASC 470-20-30-7, ABC assumes that there will be no changes to the current circumstances except for the passage of time (i.e., an IPO will not occur and there will be no changes in the number of outstanding shares). Company ABC would therefore calculate the initial effective conversion price as follows:

- Number of shares received upon conversion at original conversion price = $1,000,000 ÷ $100 = 10,000 shares.
- Number of bonus shares received (provided that there is no IPO) = 2% × 100,000 shares = 2,000 shares.
- Effective conversion price = most favorable conversion price = $1,000,000 ÷ 12,000 shares = $83.33.
Example 7-7 (continued)

Because the initial effective conversion price ($83.33) is less than the current fair value of a share ($100) as of the commitment date, the convertible notes contain a BCF at issuance. The intrinsic value of the BCF is $200,000 (12,000 shares × [$100 – $83.33]). Accordingly, ABC would recognize the intrinsic value of the BCF in equity. Specifically, ABC would record the following on the date of issuance:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>200,000</td>
</tr>
<tr>
<td>Convertible notes</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Equity — APIC</td>
<td>200,000</td>
</tr>
</tbody>
</table>

7.3.2.2.3 Issuance Costs

ASC 470-20

30-13 Costs of issuing convertible instruments do not affect the calculation of the intrinsic value of an embedded conversion option; specifically, issuance costs shall not be offset against the proceeds received in the issuance in calculating the intrinsic value of a conversion option. Issuance costs are limited to incremental and direct costs incurred with parties other than the investor in the convertible instrument. Any amounts paid to the investor when the transaction is consummated represent a reduction in the proceeds received by the issuer (not issuance costs) and shall affect the calculation of the intrinsic value of an embedded option.

In computing the effective conversion price of a convertible debt instrument, the issuer considers any issuance premium or discount but does not deduct issuance costs paid to third parties from the proceeds allocated to the convertible debt instrument. Accordingly, before computing the effective conversion price, the issuer would add back any third-party issuance costs that it had deducted from the face amount of the instrument in measuring its net carrying amount under ASC 835-30-45-1A. Amounts paid by the issuer to the investor such as commitment fees, origination fees, and reimbursements for lender expenses (e.g., for the legal fees of the holder that are associated with due diligence) represent a reduction of the proceeds, not an issuance cost. Therefore, unlike fees paid to third parties, such amounts do affect the determination of the effective conversion price.

Example 7-8

Calculation of Effective Conversion Price — Issuer Pays Fees to Third Parties and Investor

Entity A issues convertible debt to new unrelated investors for gross proceeds of $5 million. The stated conversion price is $10 per share. Entity A pays fees of $45,000 to third parties to cover its own legal costs and $55,000 to the investor to cover its legal fees associated with due diligence. In computing the effective conversion price, A deducts amounts paid to the investor, but not third-party issuance costs, from the gross proceeds. Accordingly, the effective conversion price is $9.89 ([5,000,000 – $55,000] ÷ [5,000,000 ÷ $10]).

7.3.2.2.4 Embedded Derivatives

We believe that while not explicitly addressed in ASC 470-20, the effective conversion price should be computed on the basis of the proceeds allocated to the convertible debt instrument before separation of any embedded derivatives that must be separated under ASC 815-15 (e.g., a bifurcated embedded put option). This is because any embedded derivative would be extinguished if the conversion option was exercised. Therefore, in the determination of whether a BCF exists, proceeds received for or

1 If the investor is a related party or existing investor in the entity, the issuer should consider whether the amounts paid represent a dividend.
allocated to the convertible debt instrument include any proceeds attributed to embedded derivatives that are accounted for separately under ASC 815-15.

This approach is consistent with the nonauthoritative guidance in the working draft of AICPA Technical Q&A, “Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments (2006),” which states, in part:

[S]eparately accounting for an embedded derivative under [ASC 815] (for example, an embedded prepayment option) does not affect the effective conversion price for purposes of measuring a beneficial conversion feature. That is, the proceeds received for or allocated to a convertible instrument include the proceeds ascribed to embedded derivatives that are accounted for separately from the host contract under [ASC 815]. Generally this is how it has been applied in practice. [Emphasis added]

### 7.3.2.2.5 Convertible Instruments Issued as Repayment of Nonconvertible Instrument

**ASC 470-20**

**30-19** If a convertible instrument is issued as repayment of a nonconvertible instrument at the nonconvertible instrument's maturity, the fair value of the newly issued convertible instrument shall be the redemption amount owed at the maturity date of the original instrument if both of the following conditions exist:

a. The original instrument has matured.

b. The exchange of debt instruments is not a troubled debt restructuring that would be accounted for by the issuer under Subtopic 470-60.

**30-20** After the exchange accounting occurs, any intrinsic value of the embedded conversion option in the new instrument shall be measured and accounted for under paragraph 470-20-25-5 based on the proceeds received for that instrument (the satisfaction of the redemption amount of the old instrument).

**30-21** If the original instrument is extinguished before maturity, Subtopic 470-50 shall be applied first.

Sometimes, entities issue a convertible debt instrument to repay a nonconvertible instrument that has matured. In this circumstance, ASC 470-20-30-19 and 30-20 require the issuer to treat the redemption amount owed on the original instrument's maturity date as the assumed proceeds received for the newly issued instrument unless the exchange is a TDR that must be accounted for in accordance with ASC 470-60. The issuer uses the amount of assumed proceeds to calculate the effective conversion price and the intrinsic value of any BCF associated with the newly issued convertible instrument.

If a convertible debt instrument is issued to repay a nonconvertible debt instrument before its maturity, the guidance on modifications and exchanges of debt instruments in ASC 470-50 applies (see Section 7.6.3). If the modification or exchange is treated as an extinguishment of the original debt instrument, there is no requirement to treat the redemption amount of the original instrument as the fair value of the new instrument. Instead, the fair value of the new instrument is determined in accordance with ASC 820.

### 7.3.2.2.6 Conversion Into Multiple Instruments

Sometimes, the terms of a convertible debt instrument specify that the holder will receive not just the issuer's equity shares but also other instruments (e.g., warrants on the issuer's equity shares) upon exercise of the conversion feature. In this circumstance, the conversion price represents the exercise price for both the equity shares and the other instruments that would be issued upon conversion. Because the BCF guidance focuses on conversion features that are settled solely in the issuer's equity shares, a question arises about how to measure the intrinsic value of the conversion feature under
the BCF guidance. In particular, it may not be clear how to determine the amount of proceeds or the effective conversion price of that portion of the conversion feature that is settled in the issuer’s equity shares upon conversion. As part of deliberating Issue 00-27, the EITF reached a tentative conclusion but never finalized it, and therefore the FASB did not incorporate the guidance into the Codification. Nevertheless, it is reasonable to apply the EITF’s reasoning if this issue is encountered in practice. EITF Issue 00-27, Issue Summary 1, Supplement 1 (February 28, 2008), states, in part:

> It is the FASB staff’s understanding that there is little diversity in practice concerning [the] tentative conclusions [in EITF Issue 00-27]. Although the conclusions are tentative, as there is no other authoritative literature to address these issues, reporting entities have looked to the tentative conclusions for guidance. [These] tentative conclusions have been treated as authoritative GAAP by practitioners when evaluating the accounting for the corresponding transactions.

### EITF Issue No. 00-27 (Nonauthoritative Text)

**Issue 15 — How a beneficial conversion amount should be measured when an entity issues a convertible instrument that, if converted, will result in the holder receiving common stock and other equity instruments of the issuer, such as warrants to acquire common stock of the issuer.**

52. The Task Force reached a tentative conclusion that the intrinsic value of the conversion option should be computed based on a comparison of (a) the proceeds of the convertible instrument allocated to the common stock portion of the conversion option and (b) the fair value at the commitment date of the common stock to be received by the holder upon conversion. The excess of (b) over (a) is the intrinsic value of the embedded conversion option that should be recognized by the issuer at the issuance date for the convertible instrument.

The EITF’s tentative conclusion suggests that in measuring the intrinsic value associated with a conversion feature that upon conversion will result in the delivery of equity shares and other instruments, the issuer should allocate the proceeds of the convertible instrument between (1) the portion attributable to conversion into equity shares and (2) the portion attributable to other instruments.

### 7.3.2.2.6.1 Illustration: Conversion Into a Bundle of Instruments

**EITF Issue 00-27 (Nonauthoritative Text)**

53. For example, assume Company A issues for $1 million, convertible debt with a par value of $1 million. The convertible debt is immediately convertible at a conversion price of $10 per share (that is, holder will receive 100,000 shares of Company A stock upon conversion). In addition, upon conversion, the holder also will receive 100,000 warrants to acquire Company A’s common stock. Each warrant entitles the holder to purchase 1 share of common stock at $10 per share. The warrants (which have not yet been issued) would have a fair value of $250,000 at the commitment date, and the fair value of Company A’s common stock at the commitment date is $9.

54. The beneficial conversion option amount related to the convertible instrument is $117,391 and is calculated as the difference between the $900,000 fair value of the common stock on the commitment date and the $782,609 proceeds allocated to the common stock conversion option ($1,000,000 total proceeds received × $900,000 fair value of the common stock at the commitment date ÷ $1,150,000 total fair value of all instruments received by the holder upon conversion at the commitment date). Upon conversion, the warrants would be recognized at $217,391 ($1,000,000 × $250,000 ÷ $1,150,000, or $1,000,000 – $782,609).
7.3.2.3 **Stock Price**

7.3.2.3.1 **Measurement Date**

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-9</strong> This guidance addresses when a commitment date should occur for purposes of determining the fair value of the issuer's common stock to be used to measure the intrinsic value of an embedded conversion option.</td>
</tr>
<tr>
<td><strong>30-10</strong> The commitment date is the date when an agreement has been reached that meets the definition of a firm commitment.</td>
</tr>
<tr>
<td><strong>30-12</strong> If an agreement includes subjective provisions that permit either party to rescind its commitment to consummate the transaction, a commitment date does not occur until the provisions expire or the convertible instrument is issued, whichever is earlier. Both of the following are examples of subjective provisions that permit either party to rescind its commitment to consummate the transaction:</td>
</tr>
<tr>
<td>a. A provision that allows an investor to rescind its commitment to purchase a convertible instrument in the event of a material adverse change in the issuer's operations or financial condition</td>
</tr>
<tr>
<td>b. A provision that makes the commitment subject to customary due diligence or shareholder approval.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 470-20 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Firm Commitment</strong> An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:</td>
</tr>
<tr>
<td>a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. A price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a fixed price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold.</td>
</tr>
<tr>
<td>b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.</td>
</tr>
</tbody>
</table>

For convertible debt instruments other than those issued to nonemployees for goods and services (see Section 7.3.5), the issuer evaluates whether a conversion feature is beneficial and measures its intrinsic value, if any, on the basis of the issuer’s stock price as of the instrument’s commitment date. Under ASC 470-20-30-10, the “commitment date is the date when an agreement has been reached that meets the definition of a firm commitment” — that is, as stated in ASC 470-20-20, an agreement that “specifies all significant terms” and “includes a disincentive for nonperformance that is sufficiently large to make performance probable.”

Under ASC 470-20-30-12, the commitment date is the earlier of the issuance date and the date that any subjective provisions expire. If the issuer or investor is permitted to withdraw its commitment on the basis of subjective conditions (e.g., a material adverse change in the issuer's operations or financial condition, customary due diligence, or a requirement for shareholder approval that is not perfunctory),
a firm commitment does not yet exist. Because agreements often contain subjective provisions that permit the investor to rescind the transaction, it is common for the commitment date to coincide with the issuance date, although this cannot be assumed without an analysis of the contractual terms and the specific facts and circumstances. An issuer should carefully evaluate the nature of all provisions to determine whether they are subjective in nature and would allow either party to terminate the agreement without any potential remedies.

### Example 7-9

**Identification of Commitment Date**

Issuer A enters into a convertible debt agreement on September 15. The closing date for issuance of the convertible debt was December 10. The significant terms of the agreement were not finalized and agreed upon until the issuance date. Further, the agreement became legally enforceable and gave rise to statutory rights such that a nondefaulting party could pursue remedies for default that are equivalent to the damages suffered on the closing date. In these circumstances, the December 10 closing date represents the commitment date in the evaluation of whether the debt contains a BCF.

An option to purchase convertible debt (e.g., an overallotment option that permits an underwriter to purchase more securities at a fixed price over a short period after the original issuance of convertible debt) does not represent a firm commitment to issue additional securities until such option is exercised. Accordingly, the commitment date for any securities issued under the terms of the overallotment option is not reached before the option’s exercise date.

### 7.3.2.3.2 Absence of a Public Market

Any fair value measurements that are required in the application of the BCF guidance (e.g., the fair value of the equity shares that will be delivered upon the instrument’s conversion) are performed in accordance with ASC 820. In the past, the SEC staff has stressed the importance of appropriately determining the fair value of the common stock that will be delivered upon conversion when there is not yet a public market for the common shares. In particular, the staff has been skeptical of an issuer’s assertion that no BCF exists in circumstances in which an entity is in the process of negotiating an IPO and the minimum estimated IPO price exceeds the conversion price. At the 1999 AICPA Conference on Current SEC Developments, then Professional Accounting Fellow Pascal Desroches stated, in part:

> An issue frequently encountered by the staff is determining whether a convertible debt or preferred security has a beneficial conversion feature when there is not yet a public market for the common shares.

Specifically, during this past year, the staff observed that several companies issued convertible securities within a short period before an initial public offering (IPO) with a conversion price below the expected IPO price. In each case, the company asserted that the conversion price was equal to the fair value of the common stock at the date of issuance (or commitment) of the securities and therefore the securities were not beneficially convertible. However, the fair value determined by the company was below the minimum estimated IPO price for the common stock. In some cases, this occurred even though the convertible securities were issued while the company was negotiating an IPO and the estimated IPO price range. For example, one company issued convertible preferred stock on June 8 at a price of $5.50 per share. The preferred stock was convertible at any time into common stock on a one-for-one basis. Upon the IPO, each share of preferred stock automatically converted to one share of common stock. Three days later, the company filed a registration statement for an IPO, with a price range of $11 to $13 per share. As of the date the preferred stock was issued, the company had information that the minimum estimated IPO price was $11 per share; however, the company continued to assert that the fair value of the common stock on June 8 was $5.50 per share and thus the convertible preferred stock did not contain a beneficial conversion feature.

> Convertible securities issued within a year prior to the filing of an initial registration statement with a conversion price below the initial offering price are presumed to contain an embedded beneficial conversion feature. To overcome this presumption, a registrant should provide sufficient, objective, and verifiable evidence to support its assertion that the conversion price represented fair value at the issuance or commitment date. As part of this process, registrants and their auditors should consider any valuations that an underwriter has discussed with senior management and or the board of directors.
In October 13, 2000, letter to the AICPA, then SEC Chief Accountant Lynn Turner echoed the comments that the SEC staff made about BCFs at the 1999 SEC Conference. He stated, in part:

In the evaluation of the fair value of its stock, the registrant should consider the proximity of the issuance of stock to an initial public offering, intervening events, transfer restrictions and exercise dates, profitability and financial condition of the company, and historical cash transactions involving stock with similar terms and restrictions. We consider the sufficiency of objective, verifiable evidence as the best support for the determination of fair value.

Further, the SEC's Current Accounting and Disclosure Issues in the Division of Corporation Finance (as updated August 31, 2001) states, in part:

The staff may request information about valuations that the underwriter discussed with senior management or the board of directors.

Note, however, that estimates of an IPO price or the ultimate IPO price are not necessarily a reasonable estimate of the fair value of pre-IPO transactions in an entity's stock. Paragraph 10.10 of the AICPA Accounting and Valuation Guide Valuation of Privately-Held-Company Equity Securities Issued as Compensation (2013) states, in part:

Among [the] factors [that contribute to differences between the fair value of an enterprise's equity securities in periods preceding the IPO and the ultimate IPO price] are the marketability provided by the IPO event and the reduction in the newly public enterprise's cost of capital resulting from its access to more liquid and efficient sources of capital.

7.3.3 Paid-in-Kind Features

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-16</strong> If dividends or interest on a convertible instrument must be paid in kind with the same convertible instruments as those in the original issuance and are not discretionary, the commitment date for the original instrument is the commitment date for the convertible instruments that are issued to satisfy interest or dividends requirements.</td>
</tr>
<tr>
<td><strong>30-17</strong> For purposes of the preceding paragraph, dividends or interest are not discretionary if both of the following conditions exist:</td>
</tr>
<tr>
<td>a. Neither the issuer nor the holder can elect other forms of payment for the dividends or interest.</td>
</tr>
<tr>
<td>b. If the original instrument or a portion thereof is converted before accumulated dividends or interest are declared or accrued, the holder will always receive the number of shares upon conversion as if all accumulated dividends or interest have been paid in kind.</td>
</tr>
<tr>
<td><strong>30-18</strong> In that circumstance, the intrinsic value of the embedded conversion option in the paid-in-kind instruments is measured using the fair value of the underlying stock of the issuer at the commitment date for the original issuance. Otherwise, the commitment date for the convertible instruments issued as paid-in-kind interest or dividends is the date that the interest or the dividends are accrued and the fair value of the underlying issuer stock at the recognition or declaration date shall be used to measure the intrinsic value of the conversion option embedded in the paid-in-kind instruments.</td>
</tr>
</tbody>
</table>

The terms of some convertible debt instruments include a paid-in-kind (PIK) interest payment feature that requires or permits the issuer to satisfy any interest payment obligations by issuing the same convertible debt instrument. The following are two types of such PIK interest payment features:

- On the interest payment date, the issuer satisfies the interest payment obligation by issuing additional convertible debt securities to the holder(s). That is, additional fungible securities are issued.
On each interest payment date, the issuer increases the principal amount of the original debt security to reflect the interest accrued to the benefit of the holder, which results in a proportionate increase in the number of equity shares that will be issued upon exercise of the conversion feature. For example, some convertible debt securities contain a requirement for the issuer to pay accrued interest by increasing the security's principal amount while maintaining the same conversion price (although the conversion rate per security increases). Upon conversion, the holders will receive additional common shares on the basis of the increased principal amount. Economically, other than with respect to potential differences due to the compounding terms of an instrument, such a PIK feature has the same effect as delivering additional instruments.

ASC 470-20 contains specific requirements for the issuer's identification of the commitment date for a convertible debt instrument issued as a payment of interest under a PIK feature. Because the commitment date is the measurement date in the determination of the fair value of an issuer's stock, which is then used in the calculation of a BCF's intrinsic value (see Section 7.3.2.3.1), the identification of the commitment date can affect both the determination of whether a BCF exists in such an instrument and the measurement of its intrinsic value, if any. In addition, as further discussed below, the commitment date can also affect the initial measurement of the PIK interest payment and, therefore, the determination of whether a BCF exists and the measurement of its intrinsic value. The guidance distinguishes between discretionary and nondiscretionary PIK features as follows:

<table>
<thead>
<tr>
<th>PIK Feature</th>
<th>Description</th>
<th>Commitment Date for PIK Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discretionary</td>
<td>A PIK feature is discretionary if either of the following conditions exist:</td>
<td>The date that interest is accrued (i.e., the interest cost recognition date).</td>
</tr>
<tr>
<td></td>
<td>- The issuer or the holder can elect a form of payment other than paid in kind (e.g., the issuer has the option to settle interest payment obligations by either delivering cash or making a payment in kind).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- In cases in which the convertible debt instrument or a portion thereof is converted before interest is accrued, the holder will not always receive the number of equity shares upon conversion as if all interest has been paid in kind.</td>
<td></td>
</tr>
<tr>
<td>Nondiscretionary</td>
<td>A PIK feature is nondiscretionary if both of the following conditions exist:</td>
<td>The commitment date for the original convertible debt instrument.</td>
</tr>
<tr>
<td></td>
<td>- Neither the issuer nor the holder can elect payment of interest in a form other than in kind.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Regardless of the conversion date (whether converted in whole or in part), the holder will always receive the number of equity shares upon conversion as if all interest has been paid in kind.</td>
<td></td>
</tr>
</tbody>
</table>
As described above and in ASC 470-20-30-17(b), one of the conditions for PIK interest payments to be considered nondiscretionary is that “[i]f the original instrument or a portion thereof is converted before accumulated dividends or interest are declared or accrued, the holder will always receive the number of shares upon conversion as if all accumulated dividends or interest have been paid in kind.” We believe that this guidance may be ambiguous for the following two reasons:

- It is unclear whether the words “before . . . interest [is] accrued” refer to (1) the interest earned to date, on the basis of a daily accrual approach, that is associated with the amount due on the next contractual interest payment date or (2) the interest that has not yet been earned, on the basis of a daily accrual approach, as of the conversion date. Since entities typically accrue interest more frequently than on the contractual payment dates (e.g., daily), this wording may be subject to multiple interpretations.

- It is unclear whether the word “accumulated” is intended to qualify only dividends or also interest payments. It is also unclear what portion of interest that may or may not have been accrued must be paid in kind.

As a result of this ambiguity, we believe that there are two acceptable interpretations that entities may apply consistently as an accounting policy election:

- **View A — Regardless of when during the security’s term the holder converts the instrument into equity shares, the holder must always receive upon conversion all of the interest that would have accrued during the entire life of the security (i.e., to the contractual maturity date).**

  Under this view, the issuer must know at the inception of the original convertible debt instrument, regardless of the ultimate conversion date, the exact number of equity shares that will be issued to the holder upon full conversion (i.e., conversion of the original instrument at its principal amount adjusted for PIK interest or, if PIK interest is paid through the issuance of additional convertible debt instruments, conversion of both the original convertible debt instrument at its principal amount and any additional convertible debt instruments. Potential contingent adjustments to the conversion rate for other reasons do not necessarily need to be considered). If the issuer cannot quantify the number of equity shares that will be issued or the number of equity shares will differ depending on when the instrument is converted, the PIK feature is discretionary under this view. In most cases, PIK interest payments would be discretionary under View A since entities typically do not issue convertible debt instruments that allow the holder to effectively earn future interest that would not have accrued on an early conversion (i.e., instruments with make-whole equivalents to all future interest on an undiscounted basis; see Examples 7-10 and 7-11). See Example 7-13 for discussion of the accounting if PIK interest is deemed to be nondiscretionary under this view (which would be the same as the accounting under View B, discussed below).

- **View B — Regardless of when during the security’s term the holder converts the instrument into equity shares, the holder must always receive upon conversion all of the interest that would have accrued during the entire period that the security has been outstanding (i.e., to the conversion date).**

  Under this view, the holder always receives upon conversion the number of equity shares as if all interest that has accrued (i.e., been earned to date) is paid in equity shares even if such interest has not yet been contractually paid (i.e., if conversion occurs between contractual interest payment dates). Thus, the frequency of contractual interest payment dates has no impact on the number of equity shares that the holder will receive upon conversion because a holder that elects to convert the security in between contractual interest payment dates will receive additional equity shares for the interest that has accrued from the last contractual interest payment date (see Examples 7-10 and 7-11).
The view selected will not affect the conclusion that PIK interest is discretionary in cases in which a convertible debt instrument allows either the holder or issuer to choose to pay interest in cash or in kind. In these circumstances, the PIK interest would be considered discretionary regardless of whether the entity adopted View A or View B above (see Example 7-12).

ASC 470-20 does not specifically address how to determine the initial amount to recognize for PIK interest payments. That amount, however, is important because it affects the calculation of the effective conversion price, which is compared with the commitment-date stock price (see Section 7.3.2.1), and thus could affect the determination of whether the instrument that is issued as PIK interest contains a BCF.

In Discussion Document 3 (March 8, 2001), the EITF Issue 00-27 Working Group stated, in part:

The FASB staff recommends that for purposes of recognizing a paid-in-kind dividend, the fair value of the paid-in-kind instrument should be determined on the commitment date... As a result, the fair value (and deemed proceeds) from the issuance of the paid-in-kind instrument always will be determined on the same date as the fair value of the stock underlying the conversion option in the paid-in-kind instrument. If the issuer is committed to paying dividends in the form of paid-in-kind instruments, the commitment date will be the commitment date for the original instrument. The fair value of paid-in-kind instruments issued as dividends will equal the fair value of the original instruments evidenced in the transaction. If the issuer has discretion to pay the dividends in another form such as cash, the fair value of the paid-in-kind instrument issued as a dividend will be determined on the date the issuer commits to its issuance.

Although the approach recommended by the EITF Issue 00-27 Working Group was not codified, we believe that it is generally appropriate for the initial recognition of PIK interest payments. That is, if the PIK feature is nondiscretionary, an entity initially measures the convertible debt instrument issued as PIK interest on the basis of the fair value of the original convertible debt instrument on its commitment date, which would equal the stated principal amount of the PIK interest payments only if the principal amount equaled the original convertible debt instrument's commitment-date fair value. However, if the PIK feature is discretionary, an entity initially measures the convertible debt instrument issued as PIK interest on the basis of the fair value of the PIK convertible debt instrument on its commitment date, which is generally the interest cost accrual date. While interest typically accrues on convertible debt on a daily basis, the commitment date for discretionary PIK interest does not change daily. Rather, an entity should consider the frequency with which it recognizes accrued interest and the compounding terms of the convertible debt security, among other factors, to arrive at a reasonable and practical approach to recognizing the fair value of convertible debt instruments issued as PIK interest. In determining an appropriate method, the entity should consider the definition of “commitment date” and how that definition would apply to the terms of the convertible debt instrument. On the basis of these considerations, an entity may determine that the contractual payment date is the commitment date for which the fair value of the convertible debt instrument issued as PIK interest is ultimately recorded. Because discretionary PIK interest payments are recognized at fair value, a BCF will often not exist in those convertible debt instruments.

The approach described above for recognizing discretionary PIK interest is consistent, by analogy, with ASC 505-20-30-3, which states, in part:

In accounting for a stock dividend, the corporation shall transfer from retained earnings to the category of capital stock and additional paid-in capital an amount equal to the fair value of the additional shares issued.
Example 7-10

Discretionary PIK Interest Feature — Interest Between Payment Dates Is Forfeited

Entity B issues $30 million of convertible debt that pays 5 percent stated interest per annum. The interest is payable in arrears on a semi-annual basis on March 30 and September 30 of each year, at a rate of 2.5 percent, in additional convertible debt with the same terms as the original convertible debt instrument. Thus, on each interest payment date, the holder will receive an additional convertible debt instrument with a principal amount of $750,000. The holder can convert the original instrument at any time into an equal fixed number of shares of common stock (i.e., each $1,000 principal amount of convertible debt contains the same conversion rate). The contractual terms specify that the original convertible debt instrument will mature on September 30, 20X0. If the holder elects the conversion before September 30, 20X0, it would not receive any portion of the interest that has not yet been contractually paid (e.g., if conversion occurred on June 1, the holder would not receive the interest that had accrued or would have accrued from April 1). Therefore, the PIK feature is considered discretionary under both views discussed above, and the commitment date for any convertible debt instruments issued under the PIK feature is the associated interest cost accrual date. Further, each PIK instrument is measured at its fair value as of its interest cost accrual date.

Example 7-11

Nondiscretionary PIK Interest Feature — Interest Between Payment Dates Is Paid in Kind

Company A issued a convertible debt security with the following features on July 1, 2X03, when the market price of A’s stock was $15 per share:

- A principal amount of $1 million is issued at par.
- The instrument is convertible at any time into common shares at a conversion price of $25 per share.
- Interest of 3 percent is always payable in kind through additional shares of convertible debt.
- The PIK convertible debt securities also have a fixed conversion price of $25 per share.
- The instrument matures in 10 years.
- Upon conversion, the holder receives the unpaid interest that has accrued to the conversion date.

The commitment date (see Section 7.3.2.3.1) for the original convertible security was July 1, 2X03.

Under View B above, this PIK feature is considered nondiscretionary because the holders — upon an early conversion — will always receive interest that has accrued to the conversion date. Accordingly, the commitment date for any convertible debt securities issued under the PIK feature is the July 1, 2X03, commitment date of the original convertible debt security. However, under View A above, this PIK feature is considered discretionary because the holders — upon an early conversion — will not receive all the interest that would have accrued over the security’s 10-year contractual life. Accordingly, the commitment date for any convertible debt securities issued under the PIK feature is the associated interest cost accrual date.

Example 7-12

Discretionary PIK Interest Feature — Interest May Be Paid in Cash or Paid in Kind

Company R issued convertible debt securities with interest coupons that may be paid in cash or additional convertible debt securities at R’s option. The original convertible debt security pays interest at an 8 percent per annum rate. Company R elects the form of interest payments immediately before each payment date. The conversion price in the PIK convertible debt securities is equal, at all times, to the conversion price in the original convertible debt securities. The holders of the convertible debt securities, including any additional convertible debt securities issued as payment for interest coupons, have the right to convert, at any time after issuance, any or all of the securities in their possession.

Under the BCF guidance, this PIK feature is considered discretionary since R can choose the form of payment of the interest coupons. Therefore, the commitment date for any convertible debt security issued as PIK interest is the accrual date of the interest, and the initial measurement amount of the PIK convertible debt securities is their fair value on the interest cost accrual date. This conclusion would be the same regardless of whether the issuer applied View A or View B as described above.
If PIK interest is nondiscretionary, regardless of whether the interest is added to the principal amount of the original convertible debt instrument or paid in newly issuable convertible debt securities, the issuer must use the commitment date of the original convertible debt instrument to calculate any BCF associated with the PIK interest and to recognize the PIK interest. The calculations of both the BCF, if any, and the interest cost are generally performed as if the convertible debt instrument is a zero-coupon instrument. The calculations of the BCF amounts to recognize, if any, may be complex, particularly if the original convertible instrument was initially recognized at an amount less than its commitment-date fair value, for example, because of discounts created by other freestanding financial instruments. Note that if PIK interest payments are nondiscretionary, they are initially recognized on the basis of the original convertible debt instrument’s commitment-date fair value (which may equal or approximate the stated principal amounts of the PIK interest payments). Convertible debt issued as PIK interest is not initially recognized at the amount initially recognized for the original convertible debt instrument if that amount differs from the original instrument’s commitment-date fair value. The amount initially recognized for the original convertible debt instrument on its commitment date may vary from the principal amount of the original convertible debt instrument for many reasons, including, but not limited to, the pricing of the original instrument before its commitment date or discounts recognized on the original instrument as a result of the allocation of proceeds to other freestanding financial instruments. Additional complexities arise if the PIK interest amounts are not level over the entire life of the convertible debt instrument; in such cases, the guidance in ASC 470-20-35-7(b) on instruments with multiple-step discounts may be applicable (see also Section 7.4.3).

In the unusual circumstance in which an entity issues a convertible debt instrument that, upon conversion, allows the holder to receive all PIK interest that would have accrued to the contractual maturity date regardless of the date the holder converts the interest, the entity would calculate an effective conversion rate on the basis of the fixed number of equity shares that would be issuable regardless of when conversion occurs. This number of common shares is not computed on the basis of the original conversion price excluding the capitalization of PIK interest amounts but is based on the effective conversion price after including the additional principal amount that results from all of the PIK interest. These calculations will also be necessary in the determination of the amount of interest cost to be recognized under the interest method. After determining the debt discount (if any) arising from the BCF, an entity may, in applying the interest method, treat the original convertible debt instrument in a manner similar to how it treats a zero-coupon bond for which interest is only paid on contractual maturity. If the PIK interest is added to the principal amount of the original convertible debt instrument, there will not be any BCFs in the PIK interest payments themselves because the total BCF will be calculated as of the commitment date of the original convertible debt instrument inclusive of the PIK interest payments that affect the fixed number of shares to be received regardless of when the conversion occurs (see Example 7-13).
**Example 7-13**

**Calculation of BCF for Convertible Debt Instrument With Nondiscretionary PIK Interest Payments**

Entity A issues convertible debt with the following terms:

**Contractual Terms**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue date</td>
<td>1/1/2018</td>
</tr>
<tr>
<td>Proceeds</td>
<td>$ 10,000,000</td>
</tr>
<tr>
<td>Principal amount</td>
<td>$ 10,000,000</td>
</tr>
<tr>
<td>Maturity date</td>
<td>12/31/2023 — convertible at any time at holder’s option</td>
</tr>
<tr>
<td>Conversion option — initial conversion price</td>
<td>$ 50</td>
</tr>
<tr>
<td>Fair value of A's stock — 1/1/2018</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

**Interest**

- Rate — per annum: 5.00%
- Frequency: Payable quarterly
- Payment terms: Payable in kind
- Compounding: Quarterly on 365-day convention

**Contractual Compounding**

<table>
<thead>
<tr>
<th>Date</th>
<th>Days Outstanding</th>
<th>Principal Amount Payable</th>
<th>Conversion Shares</th>
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</thead>
<tbody>
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<td>200,000</td>
</tr>
<tr>
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<td>12/31/2021</td>
<td>92</td>
<td>12,198,894</td>
<td>243,978</td>
</tr>
<tr>
<td>3/31/2022</td>
<td>90</td>
<td>12,349,291</td>
<td>246,986</td>
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<td>6/30/2022</td>
<td>91</td>
<td>12,503,235</td>
<td>250,065</td>
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<td>9/30/2022</td>
<td>92</td>
<td>12,660,810</td>
<td>253,216</td>
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<td>12/31/2022</td>
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<td>256,407</td>
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<td>90</td>
<td>12,978,430</td>
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<td>262,804</td>
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<tr>
<td>9/30/2023</td>
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<td>13,305,818</td>
<td>266,116</td>
</tr>
<tr>
<td>12/31/2023</td>
<td>92</td>
<td>13,473,508</td>
<td>269,470</td>
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Example 7-13 (continued)

**BCF Calculation**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective conversion price</td>
<td>$ 10,000,000</td>
</tr>
<tr>
<td>Allocated proceeds</td>
<td>$ 10,000,000</td>
</tr>
<tr>
<td>Divided by the number of shares received on conversion</td>
<td>269,470</td>
</tr>
<tr>
<td><strong>Effective conversion price — per share</strong></td>
<td><strong>$ 37.11</strong></td>
</tr>
<tr>
<td>Commitment-date fair value — per share</td>
<td>$ 50.00</td>
</tr>
<tr>
<td>Less: Effective conversion price — per share</td>
<td>$ 37.11</td>
</tr>
<tr>
<td>Excess</td>
<td>$ 12.89</td>
</tr>
<tr>
<td>Multiplied by the number of shares received on conversion</td>
<td>269,470</td>
</tr>
<tr>
<td><strong>BCF</strong></td>
<td><strong>$ 3,473,508</strong></td>
</tr>
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</table>

**Initial Journal Entry**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>3,473,508</td>
</tr>
<tr>
<td>Convertible debt</td>
<td>10,000,000</td>
</tr>
<tr>
<td>APIC</td>
<td>3,473,508</td>
</tr>
</tbody>
</table>

Example 7-14

**Convertible Debt With Discretionary and Nondiscretionary PIK Interest Payments**

On March 31, 20X0, Entity A issued 100,000 convertible debt securities with a principal amount of $1,000 for total proceeds of $100 million. The securities’ original maturity date is six years from the issuance date, and they earn interest at an annual rate of 10 percent per annum of the principal amount per security, compounded annually. During the first three years, A is required to pay interest in kind by delivering additional convertible debt securities. During years 4–6, A has the option to pay interest either in cash or in kind. If interest is paid in kind, the number of additional convertible debt securities is determined on the basis of the initial purchase price (i.e., A will deliver one-tenth of a convertible debt security for each outstanding convertible debt security). The holders of the convertible debt securities do not have the option to convert them before the third anniversary of their issuance, and they do not contain any put, call, or redemption features. Thus, at the end of year 3, after payment of interest in kind, there will be a total of 133,100 convertible debt securities outstanding ($100,000 × 1.10^3).

This example presents a unique fact pattern in which the PIK interest payments could be considered to contain both a discretionary and nondiscretionary element. Because there may be different ways to interpret the accounting literature, more than one view of the nature of the PIK interest payments may be acceptable. A literal read of ASC 470-20-30-17 would lead to a conclusion that all the interest is discretionary. However, it may also be acceptable to view this convertible debt instrument as (1) effectively paying no interest during years 1–3 and (2) paying interest coupons in years 4–6 through discretionary PIK interest payments. While this view would be similar to the conclusion that PIK interest is nondiscretionary during years 1–3 and discretionary for years 4–6 (since A may elect to pay interest either in cash or in kind), we believe that to appropriately apply the interest method, an entity would need to take into account the fact that interest is effectively only being paid in years 4–6. The commitment date for any additional convertible debt securities issued after March 31, 20X3, is their interest accrual date.
7.3.4 Warrants Exercisable Into Convertible Debt Instruments

Sometimes, entities issue convertible debt instruments in accordance with the exercise provisions of a physically settled warrant (e.g., a warrant on a convertible debt security). As part of its deliberations on Issue 00-27, the EITF reached several tentative conclusions related to the application of the BCF guidance in such circumstances. However, because the conclusions were never finalized by the EITF, the FASB did not incorporate them into the Codification. Nevertheless, we believe that it is generally reasonable to apply these tentative conclusions to convertible instruments issued upon the exercise of physically settled warrants to the extent that they are not exempt from the scope of the BCF guidance in ASC 470-20. Further, we believe that these tentative conclusions may be relevant in analogous fact patterns (e.g., when an instrument is convertible into another convertible instrument). EITF Issue 00-27, Issue Summary 1, Supplement 1 (February 28, 2008), states, in part:

It is the FASB staff's understanding that there is little diversity in practice concerning [the] tentative conclusions [in EITF Issue No. 00-27]. Although the conclusions are tentative, as there is no other authoritative literature to address these issues, reporting entities have looked to the tentative conclusions for guidance. [These] tentative conclusions have been treated as authoritative GAAP by practitioners when evaluating the accounting for the corresponding transactions.

Under the EITF's tentative conclusions, the BCF analysis related to physically settled warrants depends on whether they are classified as equity (see Section 7.3.4.1 below) or liabilities (see Section 7.3.4.2). While warrants to issue a convertible debt instrument would never be classified within stockholders' equity, the guidance on equity-classified warrants may still be relevant, as discussed below.

7.3.4.1 Equity-Classified Warrants

**EITF Issue 00-27 (Nonauthoritative Text)**

*Issue 13 — A company issues a warrant that allows the holder to acquire a convertible instrument for a stated exercise price. The warrant provides only for physical settlement (that is, delivery of the convertible instrument in exchange for the stated exercise price) and is classified as an equity instrument (either temporary or permanent). The issue is how to measure and when to recognize a beneficial conversion option in the underlying warrant.*

**7.3.4.1.1 Commitment Date**

**EITF Issue No. 00-27 (Nonauthoritative Text)**

*Issue 13(a) — Whether the commitment date for purposes of measuring the intrinsic value of the conversion option in the convertible instrument that is the underlying for the warrant is (a) the commitment date for the warrant or (b) the exercise date of the warrant.*

43. The Task Force reached a tentative conclusion that the date used to measure the intrinsic value of a conversion option in a convertible instrument that is the underlying for a warrant that provides only for physical settlement upon exercise and that is classified as an equity instrument should be the commitment date for the warrant, provided the issuer receives fair value for the warrant (or for the warrant and for any other instruments issued at the same time as the warrant) upon its issuance. The Task Force also reached a tentative conclusion that if the holder transfers consideration upon issuance of the warrant that is less than the fair value of the warrant (or for the warrant and for any other instruments issued at the same time as the warrant), the exercise date of the warrant should be used to measure the intrinsic value of the conversion option.

Technically, the above guidance would only apply to a warrant on a convertible stock instrument (e.g., on convertible preferred stock) because a warrant on a convertible debt instrument could never be classified in equity. However, the guidance may be applied by analogy to a liability-classified warrant on a convertible debt instrument in some limited situations, particularly when the warrant is not
subsequently remeasured during its life (i.e., the initial amount recognized is not remeasured before exercise or expiration). In this situation, provided that the issuer received fair value for the warrant (or for the warrant and any other instruments issued concurrently) upon its issuance, it would be appropriate to measure the intrinsic value of any BCF in the convertible debt instrument underlying the warrant on the warrant's commitment date.

A warrant on a convertible debt security will often be subsequently measured at fair value through earnings because it (1) meets the definition of a derivative instrument, (2) represents a liability under ASC 480-10-25-8, (3) is measured as such under the fair value option, or (4) is subject to the SEC staff's long-standing position on written options. In these circumstances, or if the issuer did not receive fair value for the warrant upon its issuance, the commitment date for the convertible debt instrument is the warrant's exercise date. We believe that if the warrant is classified as a liability and subsequently remeasured by using a measurement attribute other than fair value, such as its intrinsic value, the commitment date for measuring the BCF should also be the exercise date.

7.3.4.1.2 Deemed Proceeds

<table>
<thead>
<tr>
<th>EITF Issue 00-27 (Nonauthoritative Text)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Issue 13(b)</strong> — When measuring the intrinsic value of a conversion option embedded in a convertible instrument that is the underlying for the warrant, how the deemed proceeds for the convertible instrument should be computed.</td>
</tr>
<tr>
<td>44. The Task Force reached a tentative conclusion that the deemed proceeds for the convertible instrument are equal to the sum of the proceeds received for (or allocated to) the warrant and the exercise price of the warrant.</td>
</tr>
</tbody>
</table>

As the above guidance indicates, the EITF tentatively concluded that in the calculation of the effective conversion price of a convertible instrument issued upon the exercise of an equity-classified warrant that is evaluated on the basis of the warrant's commitment date, the deemed proceeds received for the convertible instrument should be the sum of (1) the proceeds received for (or allocated to) the warrant and (2) the warrant's exercise price. The same approach would be applied to a liability-classified warrant on a convertible debt instrument that is evaluated on the basis of the warrant's commitment date (see Section 7.3.4.1.1).

7.3.4.1.3 Conversion Value in Excess of Deemed Proceeds

<table>
<thead>
<tr>
<th>EITF Issue 00-27 (Nonauthoritative Text)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Issue 13(c)</strong> — Whether the measured intrinsic value of a beneficial conversion option in a convertible instrument that is the underlying for the warrant should be recognized at the date the warrant is issued or at the date the warrant is exercised and the convertible instrument is issued.</td>
</tr>
<tr>
<td>45. The Task Force reached a tentative conclusion that if the sum of the proceeds received for or allocated to the warrant and the exercise price of the warrant is less than the fair value of the common stock that would be received upon exercising the conversion option in the convertible instrument that is the underlying for the warrant, the excess (limited to the total proceeds originally received for or allocated to the warrant) represents a deemed distribution to the holder of the warrant for the convertible instrument that should be recognized over the life of the warrant. Any intrinsic value in excess of the proceeds received for or allocated to the warrant upon its issuance should be recognized when the warrant is exercised. On the date the warrant is exercised, that excess intrinsic value and any remaining unamortized intrinsic value measured at the date the warrant was issued should be combined and amortized over the period specified in [ASC 470-20-35-7] based on the characteristics of the convertible instrument.</td>
</tr>
</tbody>
</table>
The tentative guidance above would be applied to a liability-classified warrant on a convertible debt instrument that is evaluated on the basis of the warrant’s commitment date (see Section 7.3.4.1.1). However, we believe that this tentative conclusion is limited to noncontingent BCFs since the recognition of a contingent BCF before it is triggered would be inconsistent with the guidance for contingent BCFs (see Section 7.5). Further, in accordance with ASC 470-20-30-8, the amount of intrinsic value that can be recognized as a deemed distribution on the warrant or a discount on the convertible debt instrument cannot be greater than the deemed proceeds for the convertible instrument.

7.3.4.1.4 Illustration — Application of EITF’s Conclusions

<table>
<thead>
<tr>
<th>EITF Issue 00-27 (Nonauthoritative Text)</th>
</tr>
</thead>
<tbody>
<tr>
<td>46. The following example illustrates the application of the Task Force’s tentative conclusions on issues 13(a), 13(b), and 13(c). Assume Company A issues a freestanding warrant to Company B on January 15, 20X0, for its fair value, $20. Also assume the commitment date for the warrant is the date of issuance. The warrant provides Company B with the right during the next 2 years to exercise the warrant for $100 in cash and receive 1 share of Company A $100 par value nonredeemable convertible preferred stock. The preferred stock is convertible into 10 shares of Company A common stock 1 year after the preferred stock’s issuance date. Also assume that the terms of the warrant require physical settlement upon exercise and Company A has determined that the warrant is classified in equity. The fair value of Company A common stock on January 15, 20X0, is $15 per share. Company B exercises the warrant on July 15, 20X0, when the fair value of Company A stock is $20 per share.</td>
</tr>
<tr>
<td>47. The sum of the proceeds received for the warrant ($20) and the warrant’s exercise price ($100) equals $120, which is considered to be the proceeds of issuance of the convertible instrument pursuant to the Task Force’s tentative conclusion on Issue 13(b). The fair value (as of the commitment date of the warrant pursuant to the Task Force’s tentative conclusion on Issue 13(a)) of Company A’s common stock that would be received upon exercising the conversion option in the convertible instrument is equal to $150 ($15 per share × 10 shares). The difference between the fair value of the common stock ($150) and the proceeds of issuance of the convertible instrument ($120) is $30, which represents the intrinsic value of the conversion option in the instrument underlying the warrant (that is, a beneficial conversion option exists).</td>
</tr>
<tr>
<td>48. The amount of the beneficial conversion option recognized upon issuance of the warrant would be limited to $20, the amount of proceeds received for the warrant (pursuant to the Task Force’s tentative conclusion on Issue 13(c)). That amount would be recognized over the life of the warrant as a distribution to the warrant holder. Through the date the warrant is exercised, Company A recognized approximately $5 in amortization of the $20 beneficial conversion amount as a distribution to the warrant holder (that is, the remaining unamortized balance is $15). When the warrant is exercised and the convertible preferred stock is issued, the amount of the originally measured intrinsic value of the conversion option ($30) in excess of the proceeds received for the warrant ($20) of $10 is recognized. The sum ($25) of that $10 increment and the $15 unamortized amount of the $20 intrinsic value measured at the date the warrant was issued is immediately recognized as a deemed distribution to the holder of the convertible preferred stock because the instrument is not redeemable and is immediately convertible by the holder.</td>
</tr>
</tbody>
</table>

While the example in the tentative guidance above addresses a warrant on convertible preferred stock, it is illustrative of the accounting for a liability-classified warrant on a convertible debt instrument that is evaluated on the basis of the warrant’s commitment date (see Section 7.3.4.1.1).
Chapter 7 — Beneficial Conversion Features

7.3.4.2 Liability-Classified Warrant

EITF Issue 00-27 (Nonauthoritative Text)

Issue 14 — A company issues a warrant that allows the holder to acquire a convertible instrument for a stated exercise price. The warrant provides only for physical settlement (that is, delivery of the convertible instrument in exchange for the stated exercise price) and is classified as a liability instrument. The issues are (1) whether the commitment date for purposes of measuring the intrinsic value of a conversion option in a convertible instrument that is the underlying for a warrant is (a) the commitment date for the warrant or (b) the exercise date of the warrant, (2) how the deemed proceeds for the convertible instrument should be computed, and (3) when the intrinsic value of a beneficial conversion option in the underlying convertible instrument should be recognized.

49. The Task Force reached a tentative conclusion that the date used to measure the intrinsic value of a conversion option in a convertible instrument that is the underlying for a warrant that provides only for physical settlement upon exercise and that is classified as a liability instrument should be the exercise date for the warrant. The Task Force observed that a warrant that is classified as a liability is being marked to fair value through earnings while it is outstanding and that warrant's fair value depends in part on the value of the conversion option in the underlying convertible instrument.

If a physically settled warrant on a convertible debt instrument is classified as a liability and subsequently remeasured at fair value through earnings, the commitment date for the convertible debt instrument that would be issued upon its exercise is the warrant's exercise date.

Because a liability-classified warrant is accounted for at fair value on a recurring basis, the deemed proceeds for the convertible instrument equal the sum of the warrant's (1) exercise-date fair value and (2) exercise price (see paragraph 51 of EITF Issue 00-27). Since the fair value of the warrant reflects the value of the underlying conversion option in the convertible debt instrument issued upon the warrant's exercise, a BCF in the convertible debt instrument would not usually exist upon issuance. However, there could be a contingent BCF if there are contingent adjustments to the conversion rate (see Section 7.5).

7.3.4.2.1 Illustration — Liability-Classified Warrant

EITF Issue No. 00-27 (Nonauthoritative Text)

50. Assume that Company A issues a freestanding warrant to Company B on January 15, 20X0, for its fair value, $20. Also assume the commitment date for the warrant is the date of issuance. The warrant provides Company B with the right during the next 2 years to exercise the warrant for $100 in cash and receive Company A $100 par value convertible debt. The debt is convertible into 10 shares of Company A common stock. The fair value of Company A stock on January 15, 20X0, is $11 per share. Company B exercises the warrant on February 15, 20X1, when the fair value of Company A stock is $20 per share and the fair value and carrying amount of the warrant is $105. Also assume that the warrant terms require physical settlement upon exercise and Company A has determined that the warrant is classified as a liability.
51. Because Company A has classified the warrant as a liability instrument, the exercise date for the warrant should be used to measure and recognize the intrinsic value of the conversion option in the convertible instrument that is the underlying for the warrant. Accordingly, the fair value of the stock on the exercise date of $20 per share should be used to calculate the intrinsic value of the conversion option. When the warrant is classified as a liability instrument, the deemed proceeds for the convertible instrument ($205) should equal the sum of the carrying amount of the warrant at the exercise date ($105) and the warrant’s exercise price ($100). In this example, there is no beneficial conversion option because the amount of proceeds ($205) exceeds the fair value of the common stock into which the instrument can be converted ($200, calculated as $20 per share × 10 shares). The exercise of the warrant and resulting issuance of the convertible debt would be recorded as follows:

| Cash | 100 |
| Warrant Liability | 105 |
| Convertible Debt | 100 |
| Additional Paid-in Capital | 105 |

5 The Task Force observed that in this example the accounting resulted in recording the convertible debt at a substantial premium. In this situation, [ASC 470-20-25-13] indicates that there is a presumption that the premium represents additional paid-in capital.

7.3.5 Convertible Debt Instruments Issued to Nonemployees in Share-Based Payment Transactions

ASC 470-20

25-19 If the convertible instrument is issued for cash proceeds that indicate that the instrument includes a beneficial conversion feature and the purchaser of the instrument also provides (receives) goods or services to (from) the issuer that are the subject of a separate contract, the convertible instrument shall be recognized with a corresponding increase or decrease in the purchase or sales price of the goods or services.

30-22 To determine the fair value of a convertible instrument granted as part of a share-based payment transaction to a nonemployee in exchange for goods or services that is equity in form or, if debt in form, that can be converted into equity instruments of the issuer, the entity shall first apply Topic 718 on stock compensation.

Pending Content (Transition Guidance: ASC 718-10-65-15)

30-22 To determine the fair value of a convertible instrument granted as part of a share-based payment transaction to a nonemployee in exchange for goods or services or as consideration payable to a customer that is equity in form or, if debt in form, that can be converted into equity instruments of the issuer, the entity shall first apply Topic 718 on stock compensation.

30-23 The requirements of this Subtopic shall then be applied such that the fair value determined pursuant to Topic 718 is considered the proceeds from issuing the instrument for purposes of determining whether a beneficial conversion option exists. The measurement of the intrinsic value, if any, of the conversion option under paragraph 470-20-25-5 shall then be computed by comparing the proceeds received for the instrument (the instrument’s fair value under Topic 718) to the fair value of the common stock that the grantee would receive upon exercising the conversion option. For purposes of determining whether a convertible instrument contains a beneficial conversion feature under paragraph 470-20-25-5, an entity shall use the effective conversion price based on the proceeds allocated to the convertible instrument to compute the intrinsic value, if any, of the embedded conversion option.
Topic 718 shall be used both to measure the fair value of the convertible instrument and to measure the intrinsic value, if any, of the conversion option as of the date the convertible instrument granted as part of a share-based payment award becomes fully vested. That is, in measuring the intrinsic value of the conversion option under paragraph 470-20-25-5, the fair value of the issuer’s equity securities into which the instrument can be converted shall be determined as of the date the convertible instrument granted as part of a share-based payment award becomes fully vested, and not on the commitment date specified in this Subtopic.

Both of the following guidelines for determining the fair value of convertible instruments shall be used:

a. Subparagraph superseded by Accounting Standards Update No. 2018-07

b. Recent issuances of similar convertible instruments for cash to parties that only have an investor relationship with the issuer may provide the best evidence of fair value of the convertible instrument.

c. If reliable information under (b) is not available, the fair value of the convertible instrument shall be deemed to be no less than the fair value of the equity shares into which it can be converted.

If an entity issues a convertible instrument for cash proceeds that indicate that the instrument includes a beneficial conversion option and the purchaser of the instrument also provides (receives) goods or services to (from) the issuer that are the subject of a separate contract, the terms of both the agreement for goods or services and the convertible instrument shall be evaluated to determine whether their separately stated pricing is equal to the fair value of the goods or services and convertible instrument. If that is not the situation, the terms of the respective transactions shall be adjusted by measuring the convertible instrument initially at its fair value with a corresponding increase or decrease in the purchase or sales price of the goods or services. It may be difficult to evaluate whether the separately stated pricing of a convertible instrument is equal to its fair value. If an instrument issued to a goods or services provider (or purchaser) is part of a larger issuance, a substantive investment in the issuance by unrelated investors (who are not also providers or purchasers of goods or services) may provide evidence that the price charged to the goods or services provider represents the fair value of the convertible instrument.

Sometimes, a convertible debt instrument is issued to a nonemployee in exchange for goods or services or a combination of goods or services and cash (e.g., cash plus advisory services). In these circumstances, an entity must carefully evaluate the terms of the instrument to appropriately recognize and measure any embedded BCF since the amount of any cash proceeds received do not reflect the value of the goods or services received. At the 1999 AICPA Conference on Current SEC Developments, then Professional Accounting Fellow Pascal Desroches said, in part:

[In certain transactions reviewed by the staff, registrants have issued beneficially convertible preferred securities to third parties with whom they have existing or established business relationships beyond that of an investor-investee. On the surface these transactions appear to be purely financing transactions in which the issuer is issuing beneficially convertible preferred equity securities to raise capital. . . In cases where we have reviewed some of the governing agreements to these arrangements, . . . the staff has observed that some of these arrangements may involve elements of compensation for goods or services. In such cases, . . . the transaction is measured at fair value and is not limited to proceeds received from issuing the equity security. . . . Accordingly, I would encourage registrants and their auditors to evaluate carefully the terms of the governing agreements to these arrangements.

An entity that grants a convertible debt instrument to a nonemployee in exchange for goods and services (or a combination of cash and goods and services) must apply other GAAP for financial instruments once the convertible debt instrument has fully vested (see Section 2.8). ASC 718-10-35-9A requires an entity to apply other GAAP applicable to convertible instruments to such instruments that are granted to nonemployees in a share-based payment arrangement once “the award is fully vested.” After a convertible debt instrument becomes subject to other GAAP, the issuer must evaluate the instrument for a BCF unless either (1) the conversion option requires bifurcation under ASC 815-15 or (2) the instrument is subject to the CCF guidance.
When a convertible debt instrument is issued in exchange for goods or services (or a combination of cash and goods and services) and is subject to evaluation for a BCF (i.e., because the conversion option does not require bifurcation under ASC 815-15 and the convertible debt instrument is not subject to the CCF guidance), the issuer should first apply ASC 718 to determine the fair value of the convertible debt instrument issued to a nonemployee in return for goods and services. The issuer should then apply the steps below to recognize and measure any embedded BCF.

**Changing Lanes**

The FASB has tentatively decided to (1) amend the guidance that currently requires convertible instruments granted to nonemployees in a share-based payment transaction to become subject to the guidance in ASC 470-20 once the award is fully vested and (2) eliminate the current CCF guidance on the recognition of BCFs and the separation of convertible instruments. Under the proposed guidance, convertible instruments granted to nonemployees in a share-based payment transaction would remain within the scope of ASC 718 after vesting. However, a convertible instrument could still become subject to the guidance in ASC 470-20 and other applicable GAAP relevant to financial instruments if the instrument is modified after vesting and the nonemployee is no longer providing goods or services or is no longer a customer (see ASC 718-10-35-10). In this situation, the entity would not evaluate the convertible instrument for a BCF or separate the instrument under the CCF guidance. See Chapter 1 for further information on the Board’s proposal to simplify the accounting for certain financial instruments with characteristics of liabilities and equity.

**7.3.5.1 Step 1 — Determine the Instrument’s Effective Conversion Price on the Basis of the Proceeds Allocated**

In a manner consistent with the general requirements for determining the amount of any BCF, which are discussed in ASC 470-20-30-23, an entity “shall use the effective conversion price based on the proceeds allocated to the convertible instrument to compute the intrinsic value, if any, of the embedded conversion option.” The proceeds received from issuing the instrument are a required input in the calculation of the effective conversion price. The fair value of the convertible debt instrument under ASC 718 is considered the proceeds from issuing the convertible debt instrument in accordance with ASC 470-20.

Under ASC 718, the fair value of the convertible debt instrument is initially determined on the grant date. However, depending on the subsequent recognition and measurement of the convertible debt instrument under ASC 718, the amount that is recognized may change when the award is fully vested, which is the date on which the instrument becomes subject to other GAAP applicable to convertible instruments. Under ASC 718, the fair value of a convertible debt instrument issued to a nonemployee in a share-based payment transaction must be measured on the basis of the instrument (i.e., measuring on the basis of the goods or services exchanged is not allowed). ASC 470-20-30-25 and 30-26 provide additional guidance on determining the fair value of the convertible debt instrument for BCF measurement purposes. We do not believe that this guidance should be interpreted to mean that the fair value used for measuring the cost of the goods or services exchanged under ASC 718 should differ from the fair value used for measuring proceeds under ASC 470-20. Rather, we believe that ASC 470-20-30-25 and 30-26 are merely providing interpretive guidance that is in keeping with the measurement guidance in ASC 718. This view is consistent with ASC 470-20-30-23, which states that the fair value determined in accordance with ASC 718 is considered the proceeds from issuing the instrument in the assessment of whether a BCF exists.
Note that ASC 470-20-30-24 states, in part, that “Topic 718 shall be used both to measure the fair value of the convertible instrument and to measure the intrinsic value, if any, of the conversion option as of the date the convertible instrument granted as part of a share-based payment award becomes fully vested” (emphasis added). It is not clear whether the qualifying language (in italics) applies to the measurement of the convertible instrument or only to the measurement of the conversion feature's intrinsic value. If a convertible debt instrument is being remeasured to fair value in its entirety under the subsequent measurement guidance in ASC 718, the instrument's carrying amount and fair value as of the date the award is fully vested would be the same.

However, in many cases, a convertible debt instrument is not subsequently measured at fair value in its entirety. For example, an entity may determine that under ASC 718 a convertible debt instrument contains an equity component (e.g., a written call option on equity) and a liability component (e.g., a host debt instrument). Since the equity component would not be remeasured under ASC 718, the combined amounts would not be expected to equal the convertible instrument's fair value on the date the award is fully vested. As another example, a nonpublic entity that has elected to subsequently measure liability-classified awards at intrinsic value may subsequently measure a convertible debt instrument in its entirety at an amount that reflects any intrinsic value in the embedded conversion feature (i.e., if it concludes that the entire instrument requires classification as a liability). If the issuer uses the fair value of the convertible debt instrument on the date the instrument is fully vested as the proceeds in calculating the effective conversion price, there would often be no intrinsic value (i.e., initial BCF) because the proceeds would take into account the then-current fair value of the conversion option. However, it is not clear whether it would be appropriate to calculate the BCF on the basis of the instrument's fair value on the date it is fully vested if such proceeds differ from the fair value amount(s) used to measure the cost of the goods or services under ASC 718. On the basis of informal discussions with the FASB staff, we believe that an entity may use the fair value of the convertible debt instrument on the date it becomes fully vested as the deemed proceeds when calculating any BCF. Therefore, entities often will not recognize any BCF upon vesting, although they might be required to recognize a contingent BCF if such proceeds differ from the fair value amount(s) used to measure the cost of the goods or services under ASC 718. On the basis of informal discussions with the FASB staff, we believe that an entity may use the fair value of the convertible debt instrument on the date it becomes fully vested as the deemed proceeds when calculating any BCF. Therefore, entities often will not recognize any BCF upon vesting, although they might be required to recognize a contingent BCF after it vests if the instrument contains such a feature.

Once the issuer uses the proceeds to calculate the effective conversion price of the instrument, it proceeds to step 2.

7.3.5.2 Step 2 — Compute a BCF's Intrinsic Value by Comparing the Convertible Debt Instrument’s Effective Conversion Price to the Fair Value of the Equity Instrument the Holder Would Receive Upon Exercising the Option

As discussed above, ASC 470-20-30-24 requires an issuer to measure the fair value of the equity instrument that would be issued upon conversion “as of the date the convertible instrument granted as part of a share-based payment award becomes fully vested.” In the absence of a remeasurement of the entire convertible debt instrument at fair value under ASC 718, the measurement date of the fair value of the equity shares into which the instrument is convertible would differ from that of the proceeds used in the determination of the effective conversion price. However, as stated in Section 7.3.5.1, it is acceptable to use the fair value of a convertible debt instrument as of the date it is fully vested. As a result, an initial BCF often will not exist (although a contingent BCF may exist).
Changing Lanes

Although ASU 2018-07 significantly changes the general accounting model for share-based payment awards issued to nonemployees for goods and services, it does not change the requirement to measure a BCF for certain convertible debt instruments issued to nonemployees for goods or services once the instrument becomes subject to other GAAP applicable to financial instruments.

However, an issuer would not recognize a BCF on a convertible debt instrument until it becomes subject to other GAAP applicable to financial instruments. Once such an instrument becomes subject to ASC 470-20, it is accounted for in accordance with the subsequent measurement requirements in ASC 470-20.

### 7.3.6 Deferred Taxes

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-7</strong> For the application of Topic 740 to beneficial conversion features that result in basis differences, see paragraph 740-10-55-51.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 740-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-51</strong> The issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying this Topic. The recognition of a beneficial conversion feature effectively creates two separate instruments — a debt instrument and an equity instrument — for financial statement purposes while it is accounted for as a debt instrument, for example, under the U.S. Federal Income Tax Code. Consequently, the reported amount in the financial statements (book basis) of the debt instrument is different from the tax basis of the debt instrument. The basis difference that results from the issuance of convertible debt with a beneficial conversion feature is a temporary difference for purposes of applying this Topic because that difference will result in a taxable amount when the reported amount of the liability is recovered or settled. That is, the liability is presumed to be settled at its current carrying amount (reported amount). The recognition of deferred taxes for the temporary difference of the convertible debt with a beneficial conversion feature should be recorded as an adjustment to additional paid-in capital. Because the beneficial conversion feature (an allocation to additional paid-in capital) created the basis difference in the debt instrument, the provisions of paragraph 740-20-45-11(c) apply and therefore the establishment of the deferred tax liability for the basis difference should result in an adjustment to the related components of shareholders' equity.</td>
</tr>
</tbody>
</table>

As a result of applicable taxation requirements (e.g., the Internal Revenue Code), the recognition of a BCF in equity for a convertible debt instrument often causes the carrying amount of the debt under GAAP (the book basis) to differ from its tax basis, as determined in accordance with ASC 740-10. In practice, such a basis difference usually results in the recognition of a deferred tax liability under ASC 740-10 because (1) it is considered a temporary difference under ASC 740-10 and (2) the debt's tax basis (e.g., the entire amount of proceeds received at issuance of the debt) exceeds its book basis (i.e., the amount that remains after the separation of a BCF under ASC 470-20). Because the BCF is recognized in APIC, ASC 740-10 requires the deferred tax liability to be recognized through a charge to APIC.
7.4 Subsequent Accounting

7.4.1 Overview

ASC 470-20

35-6 Subtopic 835-10 provides overall guidance on accretion and amortization of discount. This guidance addresses the following incremental matters:
   a. Effects of beneficial conversion features
   b. Instrument with conversion feature that terminates
   c. Interest forfeiture.

35-7 Any discount recognized by the allocation of proceeds to a beneficial conversion feature under paragraph 470-20-25-5 shall be accounted for as follows: . . .
   2. For convertible debt securities, that discount shall be recognized as interest expense using the effective yield method.

The allocation of part of the carrying amount of a convertible debt instrument to a BCF that is recognized within equity creates a discount (or reduced premium) on the convertible debt instrument. This discount is amortized by using the effective interest method in accordance with ASC 835-30. The periodic amortization is recognized as interest expense in earnings:

Interest expense
Debt discount

As indicated in ASC 835-30-35-2, under the interest method, the amortization of a discount or premium is computed “in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period.” The amortization method depends on whether the instrument has a stated redemption date (see Section 7.4.2 below), involves a multiple-step discount (see Section 7.4.3), or does not possess those features (see Section 7.4.4).

7.4.2 Instruments With a Stated Redemption Date

ASC 470-20

35-7 Any discount recognized by the allocation of proceeds to a beneficial conversion feature under paragraph 470-20-25-5 shall be accounted for as follows:
   a. Instruments having a stated redemption date. If a convertible instrument has a stated redemption date (such as debt and mandatorily redeemable preferred stock), that discount shall be accreted from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs. Example 7 (see paragraph 470-20-55-28) illustrates the application of this guidance. . . .

35-10 Otherwise, if a beneficial conversion option terminates after a specified time period and the instrument is then mandatorily redeemable at a premium, any resulting discount under paragraph 470-20-25-5 shall be accreted to the mandatory redemption amount. Example 6 (see paragraph 470-20-55-25) illustrates the application of this guidance.
Debt discounts and issuance costs associated with a convertible debt instrument that contains a BCF and is not puttable by the holder should be amortized to the debt's maturity date even if the instrument's terms permit earlier conversion. If the conversion feature expires after a specified period and the instrument becomes mandatorily redeemable at a premium, the resulting discount is amortized to the mandatory redemption amount over the period to the required redemption date.

We believe that while not directly addressed in ASC 470-20, discounts and issuance costs related to convertible debt instruments that (1) contain a BCF and (2) are puttable by the investor before the stated maturity date should be amortized over the period to the first date the holder has or will obtain the unilateral ability to exercise the put option only on the basis of the passage of time (i.e., the earliest “stated redemption date”). For example, if a convertible debt instrument is immediately puttable on the date of issuance, any discount or issuance cost would be amortized immediately at inception. If the holder's ability to exercise the put option is contingent on circumstances beyond its control but the holder is expected to obtain the unilateral ability to exercise it, we believe that, by analogy to ASC 470-10-35-2, it is acceptable to amortize discounts and issuance costs over the period until the holder is expected to obtain such unilateral ability.

7.4.2.1 Illustrations — Amortization From the Date of Issuance to the Stated Redemption Date

ASC 470-20-55 contains the following illustrations in which a debt discount resulting from the recognition of a noncontingent BCF is amortized from the convertible debt instrument's date of issuance to its stated redemption date:

- In Example 6 in ASC 470-20-55-25 through 55-27, a $1 million convertible debt instrument (1) is convertible by the holder one year from issuance, (2) must be redeemed by the issuer for $1.2 million if not converted at the end of one year, and (3) has a beneficial conversion option whose intrinsic value is $200,000. The guidance states that “[t]he total proceeds of $1 million are therefore allocated as follows: $800,000 to the convertible debt and $200,000 to the conversion option (recognized as additional paid-in capital). The debt is then accreted from $800,000 to the $1.2 million redemption amount over the 1-year period to the required redemption date.”

- In Cases A, E, and F of Example 7 in ASC 470-20-55-29 through 55-60A, a $1 million convertible debt instrument has a redemption date on the fifth anniversary of issuance and is convertible on the issuance date. For each case, the guidance states that “[b]ecause the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.”

- In Case B of Example 7 in ASC 470-20-55-34 through 55-38, a $1 million convertible debt instrument has a redemption date on the fifth anniversary of issuance and is convertible one year from the issuance date. The guidance states that “[b]ecause the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.”

Although the guidance in ASC 470-20-35-7 suggests that the amortization of the discount created by a BCF should begin on the issuance date, amortization cannot begin before the discount has been recognized. Thus, a discount resulting from the recognition of a contingent BCF (see Section 7.5) should be amortized from the date the contingent BCF is triggered rather than the date the instrument is issued. This approach is consistent with the implementation guidance in ASC 470-20-55, which illustrates how the amortization of a discount associated with a contingent BCF begins when the contingent BCF is first recognized:
• In Example 5 in ASC 470-20-55-22 through 55-24, Entity A issues a $1 million convertible debt instrument that is convertible at a $10 conversion price. The guidance states that “[i]f Entity A subsequently issues common stock at a price of $8 per share, the holder’s conversion price adjusts to $7.20 . . . . The incremental intrinsic value that results from triggering the contingent option . . . would be recognized upon the subsequent issuance of common stock at the $8 per share price. The accretion of this discount would be required from the date the common stock was subsequently issued at $8 per share.”

• In Case D of Example 7 in ASC 470-20-55-44 through 55-48, a $1 million convertible debt instrument has a redemption date on the fifth anniversary of issuance and is convertible upon an IPO. The guidance states that “[i]f the IPO were completed on the third anniversary of the debt issuance, the discount amount would be recorded at that date and amortized over a two-year period ending on the stated redemption date of the debt.”

We believe that by analogy to the guidance on increasing-rate debt in ASC 470-10-35-2, it may in limited circumstances be acceptable for entities to recognize discounts resulting from recurring conversion ratio adjustments that represent contingent BCFs as an expense (i.e., a period cost).

**Example 7-15**

**Convertible Debt With Recurring Contingent BCFs**

Entity X, which has a history of paying stable recurring dividends on its outstanding common stock, issued convertible debt with a provision that reduces the conversion price each time X pays such dividends. Because X has determined that the dividend equivalent applied to reduce the conversion price represents a contingent BCF, it will recognize an incremental debt discount each time it pays a dividend. In these circumstances, the recurring conversion price adjustments may in effect represent an incremental interest payment on the convertible debt that should be recognized as a period cost. If each discount were to be amortized to the stated redemption date, X would recognize interest expense at an increasing rate as the redemption date approaches since each discount recognized would be amortized over a shorter period than the previous one.

**7.4.2.2 Illustration — BCF That Expires and Instrument Becomes Mandatorily Redeemable at a Premium**

**ASC 470-20**

*Example 6: Beneficial Conversion Option Terminates After a Specified Time Period and Instrument Then Mandatorily Redeemable at a Premium*

55-25 This Example illustrates the guidance in paragraph 470-20-35-10.

55-26 Assume Entity A issues for $1 million a convertible debt instrument that is convertible by the holder 1 year from issuance into 120,000 shares of Entity A common stock (fair value of Entity A’s common stock at the commitment date is $10). If the instrument is not converted at the end of 1 year, Entity A is required to redeem it for $1.2 million.

55-27 The debt instrument contains a beneficial conversion option with an intrinsic value of $200,000 — that is, (120,000 shares x $10 per share) (which is equal to the fair value of stock to be received upon conversion) – $1 million (proceeds received). The total proceeds of $1 million are therefore allocated as follows: $800,000 to the convertible debt and $200,000 to the conversion option (recognized as additional paid-in capital). The debt is then accreted from $800,000 to the $1.2 million redemption amount over the 1-year period to the required redemption date in accordance with this Subtopic.
As illustrated in Example 6 above, if a convertible debt instrument includes a BCF that expires after a specified period and the instrument then becomes mandatorily redeemable at a premium, the initial carrying amount of the instrument (after separation of the BCF) is accreted to the mandatory redemption amount (including the redemption premium) over the period to the mandatory redemption date.

Example 6 implies that Entity A makes the following entries at issuance:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>400,000</td>
</tr>
<tr>
<td>Debt</td>
<td>1,200,000</td>
</tr>
<tr>
<td>APIC (BCF)</td>
<td>200,000</td>
</tr>
</tbody>
</table>

Over the life of the instrument, Entity A makes the following cumulative entries to reflect the amortization of the discount:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>400,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>400,000</td>
</tr>
</tbody>
</table>

### 7.4.3 Instruments With a Multiple-Step Discount

**ASC 470-20**

- **35-7** Any discount recognized by the allocation of proceeds to a beneficial conversion feature under paragraph 470-20-25-5 shall be accounted for as follows: . . .
  
  - **b.** Instruments involving a multiple-step discount. If an instrument incorporates a multiple-step discount and does not have a stated redemption date, that discount shall be amortized over the minimum period in which the investor can recognize that return. However, amortization recognized may require adjustment to ensure that the discount amortized at any point in time is not less than the amount the holder of the instrument could obtain if conversion occurred at that date. This method can be expressed as requiring cumulative amortization equal to the greater of the following:
    1. The amount derived using the effective yield method based on the conversion terms most beneficial to the investor
    2. The amount of discount that the investor can realize at that interim date. . .

**Example 10: Multiple-Step Discount**

- **55-69** This Example illustrates the application of paragraphs 470-20-30-15 and 470-20-35-7 to an instrument that incorporates a multiple-step discount. If an instrument provides for a 15 percent discount to the market price after 3 months, a 25 percent discount after 6 months, a 35 percent discount after 9 months, and a 40 percent discount after 1 year, paragraph 470-20-30-15 requires that the computation of the intrinsic value be made using the conversion terms that are most beneficial to the investor; that is, the discount would be 40 percent and the amortization period would be 1 year. However, paragraph 470-20-35-7 indicates that the amortization recognized may require adjustment to ensure that the discount amortized at any point in time is not less than the amount the holder of the instrument could obtain if conversion occurred at that date. That is, at the end of 3 months, at least the 15 percent discount should have been recognized. Paragraph 470-20-35-7(a) states that, if a convertible instrument has a stated redemption date, the discount shall be accreted from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs.
If the conversion price of a convertible debt instrument changes with the passage of time, discounts and issuance costs are amortized so that cumulative amortization as of each reporting date equals the greater of (1) the amount the investor can realize as of that reporting date and (2) an amount calculated by using the effective interest method. Although the effective interest rate is determined on the basis of the conversion terms that will be most favorable to the investor over the life of the convertible debt, any discount is amortized over the period until the earliest stated redemption date.

### 7.4.4 Other Instruments

**ASC 470-20**

<table>
<thead>
<tr>
<th>35-7</th>
<th>Any discount recognized by the allocation of proceeds to a beneficial conversion feature under paragraph 470-20-25-5 shall be accounted for as follows: . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>c.</td>
<td>All other instruments. If a convertible instrument does not involve a multiple-step discount and does not have a stated redemption date (such as perpetual preferred stock), that discount shall be amortized from the date of issuance to the earliest conversion date as follows:</td>
</tr>
<tr>
<td></td>
<td>1. For convertible preferred securities, that discount (which is analogous to a dividend) shall be recognized as a return to the preferred shareholders using the effective yield method.</td>
</tr>
<tr>
<td></td>
<td>2. For convertible debt securities, that discount shall be recognized as interest expense using the effective yield method.</td>
</tr>
</tbody>
</table>

All discounts retain their character such that a discount resulting from the accounting for a beneficial conversion option is amortized from the date of issuance to the earliest conversion date. For SEC registrants, other discounts on perpetual preferred stock that has no stated redemption date but that is required to be redeemed if a future event that is outside the control of the issuer occurs (such as a change in control) shall be accounted for in accordance with Section 480-10-599.

Convertible debt instruments almost always have a stated redemption date. As a result, the guidance in ASC 470-20-35-7(c) generally applies only to nonputtable perpetual convertible stock that does not include a multiple-step discount. However, there are limited circumstances in which an entity may issue a convertible instrument that is debt in legal form but does not have any stated redemption date. In those circumstances, the convertible instrument is classified as a liability and the guidance requiring application of the effective yield method to the earliest conversion date is applicable.

Although ASC 470-20-35-7(c) suggests that amortization should begin from the issuance date, amortization of a contingent BCF begins when it is first recognized.

**Example 7-16**

**Perpetual Convertible Debt With Noncontingent BCF**

Entity A issues for cash proceeds of $12 million a perpetual convertible instrument that is debt in legal form and contains a noncontingent BCF whose intrinsic value is $2 million. The convertible instrument has no maturity date or redemption provisions held by the holder and is immediately convertible upon issuance. Therefore, the earliest conversion date is the issuance date, and the discount associated with the BCF would be amortized in full as of the issuance date and recognized as interest expense. Entity A makes the following journal entry:

<table>
<thead>
<tr>
<th>Cash</th>
<th>12,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Equity — convertible debt</td>
<td>12,000,000</td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>2,000,000</td>
</tr>
</tbody>
</table>
The guidance in ASC 470-20-35-7 suggests that if a convertible debt instrument without a stated redemption date has a discount in addition to the one created by the BCF, each discount retains its character, which may require an entity to track and account for each discount separately. Although ASC 470-20-35-7 refers to “all discounts” without specifically limiting the scope of this guidance to any specific subset of convertible instruments, the EITF intended the guidance to be applied to convertible instruments that do not have a stated redemption date; thus, we believe that this guidance is only relevant to convertible preferred stock instruments that are subject to classification in temporary equity in their entirety.

**Connecting the Dots**
For further discussion of the application of the SEC’s guidance on temporary equity, see Chapter 9 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*.

### 7.5 Contingent BCFs

#### 7.5.1 Concept of Contingent BCF

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-8</strong> Certain convertible instruments may have a contingently adjustable conversion ratio; that is, a conversion price that is variable based on future events such as any of the following:</td>
</tr>
<tr>
<td>a. A liquidation or a change in control of the entity</td>
</tr>
<tr>
<td>b. A subsequent round of financing at a price lower than the convertible instrument’s original conversion price</td>
</tr>
<tr>
<td>c. An initial public offering at a share price lower than an agreed-upon amount.</td>
</tr>
<tr>
<td><strong>35-2</strong> The guidance in the following paragraph applies to an instrument with either of the following characteristics:</td>
</tr>
<tr>
<td>a. The instrument becomes convertible only upon the occurrence of a future event outside the control of the holder.</td>
</tr>
<tr>
<td>b. The instrument is convertible from inception but contains conversion terms that change upon the occurrence of a future event.</td>
</tr>
</tbody>
</table>

Contingent BCFs, which are triggered by uncertain future events or circumstances, include BCFs that are (1) only contingently exercisable (e.g., a conversion feature that can only be exercised if an IPO or a qualifying financing were to occur) or (2) associated with contingently adjustable conversion ratios (e.g., a conversion ratio that resets upon a change of control). However, a standard antidilution provision would not be analyzed as a contingent BCF (see Section 7.5.1.1). Similarly, a conversion rate that adjusts only if an uncertain future event or circumstance does not occur is not a contingent BCF because it will occur (i.e., become exercisable) upon the mere passage of time without a change in circumstances. Rather, the initial active BCF, if any, is measured under the assumption that there are no changes other than the passage of time. However, the actual occurrence of the uncertain event or circumstance and the resulting adjustment to the conversion rate may lead to the recognition of a contingent BCF, an elimination of a BCF, or an increase or a reduction in the amount of the BCF.

If the issuer of a convertible debt instrument that contains a contingent BCF irrevocably elects to account for the instrument under the fair value option in ASC 825-10, it is exempt from the contingent BCF guidance in ASC 470-20 (see Sections 2.5 and 7.2.4).
The requirement to identify and measure BCFs on the basis of the commitment-date stock price applies to both noncontingent and contingent BCFs. For a contingent BCF, the stock price when the contingency is triggered is not relevant to the analysis. Accordingly, an issuer may be required to recognize the accounting effect of a contingent BCF that is in-the-money as of the commitment date even if the adjusted conversion price exceeds the current stock price (i.e., the conversion feature is out-of-the-money) as of the date the contingent BCF is triggered. While a contingent BCF is measured on the basis of the commitment-date stock price, it is not recognized until the contingency occurs.

Note that a contingent BCF must involve an exercise contingency (e.g., a conversion feature contingent on an IPO), a conversion rate adjustment (e.g., a down-round feature), or both. ASC 815-40-15 contains detailed guidance on evaluating whether an exercise contingency or adjustment provision precludes a conclusion that a contract or feature is indexed to the entity’s own equity. If the equity conversion feature is not considered indexed to the issuer’s equity under ASC 815-40, the issuer should evaluate whether it must be bifurcated as an embedded derivative under ASC 815 (see Section 2.3 and Appendix A). The BCF guidance in ASC 470-20 does not apply to equity conversion features that are bifurcated as embedded derivatives from convertible debt instruments (see Section 7.2.2).

### 7.5.1.1 Antidilution Provisions

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Antidilution</strong></td>
</tr>
<tr>
<td>An increase in earnings per share amounts or a decrease in loss per share amounts.</td>
</tr>
<tr>
<td><strong>Down Round Feature</strong></td>
</tr>
<tr>
<td>A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.</td>
</tr>
<tr>
<td>A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.</td>
</tr>
<tr>
<td><strong>Equity Restructuring</strong></td>
</tr>
<tr>
<td>A nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.</td>
</tr>
<tr>
<td><strong>Standard Antidilution Provisions</strong></td>
</tr>
<tr>
<td>Standard antidilution provisions are those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the value of the conversion option.</td>
</tr>
</tbody>
</table>

Often, the terms of convertible debt instruments contain contingent adjustments to the conversion ratio to protect the holder from dilution of the value of the conversion feature upon the occurrence of specified events (e.g., stock splits, stock dividends, or tender offers). If such an adjustment term meets the definition of a standard antidilution provision, the feature does not represent a contingent BCF because it does not give the holder any additional benefit or value. This reasoning is consistent with the guidance in ASC 470-20-25-11(c), which implies that — for traditional convertible debt to which ASC 470-20-25-12 applies — an entity should not separately recognize a conversion feature for which
the conversion price adjusts under an antidilution provision (see Section 4.2). In addition, ASC 815-40-25-41 states, in part (see also Section 5.5 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity):

Standard antidilution provisions contained in an instrument do not preclude a conclusion that the instrument is convertible into a fixed number of shares.

If the adjustment terms do not meet the definition of a standard antidilution provision, however, the feature may represent a contingent BCF that would need to be evaluated under the BCF guidance in ASC 470-20 unless it is exempt from the scope of the guidance (see Section 7.2).

A contractual term is considered a standard antidilution provision if it (1) results in an adjustment to the conversion ratio upon the occurrence of an equity restructuring transaction (i.e., in accordance with the ASC master glossary definition of equity restructuring, a “nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying a [contract] to change”) and (2) is designed to maintain the value of the conversion feature rather than provide incremental value to the holder.

Certain events may result in an adjustment to the conversion ratio under the contractual terms of a convertible debt instrument. The table below provides examples of adjustments that may qualify as standard antidilution provisions and adjustments that may be nonstandard. Note that the assessment of whether the adjustment meets the definition of a standard antidilution provision could differ depending on how the provision is worded and other facts and circumstances (e.g., whether the adjustment provides incremental value to the holder).

<table>
<thead>
<tr>
<th>Standard</th>
<th>Nonstandard</th>
</tr>
</thead>
<tbody>
<tr>
<td>• <em>Stock dividend</em> — The issuance of shares</td>
<td>• <em>Down round</em> — The issuance of common shares at</td>
</tr>
<tr>
<td>of common stock as a dividend or distribution</td>
<td>a price lower than the conversion price in effect</td>
</tr>
<tr>
<td>to all common stockholders.</td>
<td>immediately before such issuance.</td>
</tr>
<tr>
<td>• <em>Stock split</em> — A subdivision of shares of</td>
<td>• <em>Recurring cash dividends</em> — Recurring quarterly</td>
</tr>
<tr>
<td>common stock.</td>
<td>cash dividends to all common shareholders.</td>
</tr>
<tr>
<td>• <em>Reverse stock split</em> — A combination of</td>
<td>• <em>Tender offer or exchange offer</em> — Distributions</td>
</tr>
<tr>
<td>outstanding shares of common stock.</td>
<td>of cash or other consideration in respect of a</td>
</tr>
<tr>
<td>• <em>Spinoff</em> — The dividend or other</td>
<td>tender offer or exchange offer for the issuer's</td>
</tr>
<tr>
<td>distribution to all holders of common stock,</td>
<td>common stock such that the cash and the value of</td>
</tr>
<tr>
<td>evidence of indebtedness, or assets on a pro</td>
<td>any such other consideration per share validly</td>
</tr>
<tr>
<td>rata basis.</td>
<td>tendered or exchanged exceeds the closing sale</td>
</tr>
<tr>
<td>• <em>Rights offering</em> — The dividend</td>
<td>price per share of the issuer's common stock.</td>
</tr>
<tr>
<td>distribution or other issuance to all</td>
<td>• <em>Equity restructuring</em> — Recapitalization</td>
</tr>
<tr>
<td>holders of common stock on a pro rata</td>
<td>through a large, nonrecurring cash dividend.</td>
</tr>
<tr>
<td>basis of rights or warrants entitling them</td>
<td></td>
</tr>
<tr>
<td>to purchase shares of common stock or</td>
<td></td>
</tr>
<tr>
<td>securities convertible into common stock at</td>
<td></td>
</tr>
<tr>
<td>less than (or with a conversion price per</td>
<td></td>
</tr>
<tr>
<td>share less than) the current market price</td>
<td></td>
</tr>
<tr>
<td>as of the date of issuance.</td>
<td></td>
</tr>
<tr>
<td>• <em>Equity restructuring</em> — Recapitalization</td>
<td></td>
</tr>
<tr>
<td>through a large, nonrecurring cash dividend.</td>
<td></td>
</tr>
</tbody>
</table>

An adjustment that occurs upon the company’s tender or exchange offer to acquire common stock does not meet the definition of an equity restructuring because such offers are reciprocal (i.e., shareholders tender common shares in exchange for consideration). Accordingly, a conversion ratio adjustment triggered by a tender or exchange offer does not represent a standard antidilution provision, and it may represent a contingent BCF that must be evaluated if the contingency is resolved.
Furthermore, a down-round protection provision that reduces the conversion price if new equity shares are issued at a price below the conversion price (or issues new warrants or convertible instruments with a lower exercise price) is not a standard antidilution provision since it gives the holder a benefit that is not available to the other holders of the issuer's equity shares. As a result, the issuer may be required to recognize the down-round protection provision as a contingent BCF if the provision is triggered (see Section 7.5.3.2.1).

### 7.5.2 Recognition

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-20</strong> Changes to the conversion terms that would be triggered by future events not controlled by the issuer shall be accounted for as contingent conversion options, and the intrinsic value of such conversion options shall not be recognized until and unless the triggering event occurs. The term recognized is used to mean that the calculated intrinsic value is recorded in equity with a corresponding discount to the convertible instrument.</td>
</tr>
<tr>
<td><strong>35-3</strong> A contingent beneficial conversion feature in an instrument having the characteristics in the preceding paragraph shall not be recognized in earnings until the contingency is resolved.</td>
</tr>
<tr>
<td><strong>55-16</strong> If the amortized amount of discount on the convertible instrument resulting from the initial measurement of the intrinsic value of the conversion option before the adjustment exceeds the remeasured intrinsic value of the conversion option after the adjustment, the excess amortization charge should not be reversed. Any unamortized amount of that original discount amount that exceeds the amount necessary for the total discount (amortized and unamortized) to be equal to the intrinsic value of the adjusted conversion option should be reversed through a debit to paid-in capital (as an adjustment to the intrinsic value measurement of the conversion option). The adjusted unamortized discount, if any, should be amortized using the interest method pursuant to the recommended guidance in this Subtopic.</td>
</tr>
</tbody>
</table>

Although there is no accounting recognition for a contingent BCF upon the issuance of a convertible debt instrument, an issuer should monitor whether the recognition of a contingent BCF is required when a contingent conversion feature is triggered or the conversion price is adjusted in accordance with the instrument’s contractual terms.

If the intrinsic value of a conversion feature is remeasured because of a conversion price adjustment, an entity is not permitted to reverse any previous amortization of a discount that resulted from the recognition of a BCF in the instrument. For example, the entity cannot reverse prior amortizations even if the amount that has already been amortized exceeds the remeasured intrinsic value of the conversion feature. Further, the amount of the remaining unamortized discount is adjusted on the basis of the relationship between the amount previously amortized and the remeasured intrinsic value:

- If the amount already amortized in connection with a previously recognized BCF as of the date the conversion price is adjusted exceeds the remeasured intrinsic value of the conversion feature, any remaining unamortized amount of the original discount related to the BCF is reversed through a debit to paid-in capital (Dr: APIC (BCF); Cr: Discount). In this circumstance, no further amortization related to the remeasured intrinsic value is required since the adjusted unamortized discount associated with the BCF is zero.

- If the remeasured intrinsic value exceeds the amount that has already been amortized in connection with the previously recognized BCF, the entity adjusts the remaining unamortized discount to equal the difference between (1) the remeasured intrinsic value and (2) the amount that has already been amortized. An increase in the discount is recognized by crediting APIC (Dr: Discount; Cr: APIC (BCF)), and a decrease is recognized by debiting APIC (Dr: APIC (BCF); Cr: Discount). The adjusted unamortized discount is then amortized by using the interest method (see Section 7.4).
Example 7-17

**Recognition of Contingent BCF**

A convertible debt instrument is issued at its principal amount for cash proceeds of $1 million. The instrument contains a contingent BCF that has an intrinsic value of $200,000 as of the commitment date.

The journal entry on the date of issuance is as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Debt</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

Entry on the date the contingent BCF is triggered:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt discount</td>
<td>200,000</td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>200,000</td>
</tr>
</tbody>
</table>

Example 7-18

**Contingent BCF if IPO Occurs**

A convertible debt instrument contains a conversion option that is only exercisable if there is an IPO. The determination of whether a BCF exists is based on the market price of the underlying shares on the instrument's commitment date rather than on the date of the IPO. However, any BCF that arises as a result of the IPO is recognized only when an IPO occurs.

7.5.2.1 Illustration — Recognition of Contingent BCF

**ASC 470-20**

*Example 7: Beneficial Conversion Features or Contingently Adjustable Conversion Ratios*

55-28 The following Cases illustrate the guidance for beneficial conversion features or contingently adjustable conversion ratios for convertible securities: . . .

- d. Instrument contains a fixed percentage conversion feature dependent on a future event (Case D). . . .

**Case D: Instrument Containing a Fixed Percentage Conversion Feature Dependent on a Future Event**

55-44 This Case illustrates the guidance in paragraphs 470-20-35-2 through 35-3.

55-45 This Case has the following assumptions:

- a. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance
- b. Convertible upon an initial public offering
- c. Convertible at 80 percent of stock price at commitment date (that is, $40)
- d. Fair value of common stock at commitment date equals $50 per share.
ASC 470-20 (continued)

55-46 The calculation is as follows.

<table>
<thead>
<tr>
<th>Initial public offering price</th>
<th>$50</th>
<th>$60</th>
<th>$70</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock price at commitment date</td>
<td>$50</td>
<td>$50</td>
<td>$50</td>
</tr>
<tr>
<td>80% of stock price at commitment date</td>
<td>$40</td>
<td>$40</td>
<td>$40</td>
</tr>
<tr>
<td>Intrinsic value of beneficial conversion feature at commitment date</td>
<td>$250,000(a)</td>
<td>$250,000(b)</td>
<td>$250,000(c)</td>
</tr>
</tbody>
</table>

(a) \( (1,000,000 \div 40) \times (50 - 40) \)
(b) \( (1,000,000 \div 40) \times (50 - 40) \)
(c) \( (1,000,000 \div 40) \times (50 - 40) \)

55-47 The instrument is not convertible at the commitment date, however it will become convertible and that conversion feature will be beneficial if an initial public offering is completed. The intrinsic value of the beneficial conversion feature is calculated at the commitment date using the stock price as of that date, that is, $250,000. However, that amount would only be recorded at the date an initial public offering is completed. If the IPO were completed on the third anniversary of the debt issuance, the discount amount would be recorded at that date and amortized over a two-year period ending on the stated redemption date of the debt.

55-48 Entry at issuance.

| Cash | $1,000,000 |
| Debt | $1,000,000 |

Entry at initial public offering:

| Debt discount | $250,000 |
| Additional paid-in capital | $250,000 |

7.5.3 Measurement

ASC 470-20

25-6 A contingent beneficial conversion feature shall be measured using the commitment date stock price (see paragraphs 470-20-30-9 through 30-12) but, as discussed in paragraph 470-20-35-3, shall not be recognized in earnings until the contingency is resolved.

As discussed in Section 7.3.2.2.2, the intrinsic value of a conversion feature for which the conversion price is not fixed is measured on the basis of a comparison of (1) the most favorable conversion price available to the holder on the conversion date if there were no changes in circumstances except for the passage of time and (2) the commitment-date stock price. Therefore, if there is a change in circumstances such that the conversion terms are adjusted, the entity remeasures the conversion feature's intrinsic value to reflect the most favorable conversion price that would be available under the new circumstances provided that those circumstances would not change other than for the passage of time. For instance, if the conversion price is adjusted on the basis of the issuer's most recently reported earnings as of the conversion date, the intrinsic value is recomputed on the basis of the effective conversion price that would apply on the reporting date. Note, however, that the stock price that is used to remeasure the intrinsic value is the original commitment-date stock price (see Section 7.3.2.3) rather
than the stock price on (1) the date the intrinsic value is remeasured, (2) the reporting date, or (3) the conversion date.

The method used to remeasure a feature’s intrinsic value depends on whether the number of shares the holder would receive upon conversion (if the contingency were to be met) is known on the instrument’s commitment date. In other words, because the number of shares that will be received upon conversion is mathematically related to the effective conversion price (i.e., the amount of proceeds allocated to the instrument at inception divided by the number of shares that will be received upon conversion), the measurement of a contingent BCF depends on whether the amount by which the effective conversion price would adjust (if the contingency was met) is known at inception.

For a discussion of how to compute the revised intrinsic value if the number of incremental shares is known at inception (e.g., if an IPO would reduce the conversion price by a fixed monetary amount), see Section 7.5.3.1 below.

For a discussion of how to compute the incremental intrinsic value if the number of incremental shares is indeterminable at inception (e.g., if the issuance of shares at a price below the original conversion price would reset the conversion price to that share price), see Section 7.5.3.2.

### 7.5.3.1 Fixed Number of Incremental Shares

If the number of incremental shares that will be issued upon conversion if the contingency is met is known at inception, the revised intrinsic value is determined by multiplying (1) any excess of the commitment-date fair value of each share of common stock or other securities into which the instrument is convertible ($S_0$) over the new effective conversion price ($X_1$) by (2) the number of shares into which the instrument is convertible under the new circumstances ($n_1$). Algebraically, this can be expressed as follows:

$$ \text{New intrinsic value} = (\max (S_0, X_1) - X_1) \times n_1 $$

Because the calculation of the new effective conversion price ($X_1$) depends on the number of shares to be issued ($n_1$) at that price and the amount of proceeds ($P_0$) allocated to the instrument (i.e., $X_1 = P_0 / n_1$), an alternative method of determining the new intrinsic value is to calculate the excess, if any, of (1) the commitment-date fair value of the securities into which the instrument is convertible ($S_0 \times n_1$) over (2) the amount of proceeds allocated to the instrument ($P_0$). Algebraically, this can be expressed as follows:

$$ \text{New intrinsic value} = \max ((S_0 \times n_1) - P_0, 0) $$

Note that these formulas reflect the entire revised BCF. If a BCF was previously recognized, the adjustment on the date the contingent BCF is triggered must take into account the previously recognized BCF (see Section 7.5.2).

### ASC 470-20

**Example 4A: Resets**

**55-19A** This Example illustrates the guidance in paragraph 470-20-35-4.

**55-20** Assume Entity A issues for $1 million a convertible debt instrument with a conversion option that allows the holder to convert the instrument at $12.50 per share for 80,000 shares of Entity A’s common stock. The fair value of the common stock is $10 at the commitment date. The debt instrument also provides that if the market price of Entity A’s common stock falls to $7 or less at any point during the conversion term, then the conversion price resets to $8.75 per share (the instrument would then become convertible into 114,286 shares).
An implicit assumption in Example 4A above is that the conversion feature is not required to be bifurcated as a derivative instrument under ASC 815-15-25-1 since that would have caused the instrument to be outside the scope of the BCF guidance in ASC 470-20.

Example 4A implies that Entity A make the following entry at issuance:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Debt</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

If the stock price falls to $7, Entity A makes the following entry:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt discount</td>
<td>142,858</td>
</tr>
<tr>
<td>APIC (BCF)</td>
<td>142,858</td>
</tr>
</tbody>
</table>

**Example 7-19**

**Example 3 in ASC 470-20-55**

Example 3 in ASC 470-20-55-13 through 55-17 illustrates the accounting for the remeasurement of the intrinsic value of a conversion feature that results from a conversion price adjustment. The pertinent assumptions are as follows (see Section 7.3.2.2.2.1):

- Entity A "issues for $1 million a convertible instrument that is convertible 4 years after issuance at a conversion price of $10 per share."
- The "fair value of the stock is $10 at the commitment date."
- "The instrument also contains a provision that the conversion price adjusts from $10 to $7 per share if Entity A does not have an initial public offering with a per-share price of $13 or more within 3 years."

An implicit assumption in Example 3 is that the conversion feature is not required to be bifurcated as a derivative instrument under ASC 815-15-25-1 even though it would not qualify as equity under ASC 815-40 (see Section 7.3.2.2.2).

Initially, the intrinsic value of the conversion feature is determined on the basis of (1) the conversion price that would apply if no IPO occurs (i.e., $7), because that is the price that applies if there were no change in circumstances after the issuance date other than the passage of time, and (2) the commitment-date stock price (i.e., $10). Accordingly, the initial intrinsic value of the conversion feature is $428,571 (computed as ($1 million + $7) shares × ($10 – $7)).

The entry on the date of issuance is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Discount</td>
<td>428,571</td>
</tr>
<tr>
<td>Convertible instrument</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>428,571</td>
</tr>
</tbody>
</table>
ASC 470-20

55-17 For example, assume in this Case that Entity A had an amortized discount of $85,714 and the remaining unamortized discount was $342,857 at the time it completed an initial public offering for a per-share price of more than $13. Entity A would remeasure the intrinsic value of the conversion option based on the adjusted conversion price of $10 per share and determine that there is no intrinsic value of the adjusted conversion option because the adjusted conversion price equals the fair value of the common stock at the initial commitment date. Entity A would reverse the entire $342,857 of remaining unamortized discount (credit) with an offsetting entry (debit) to additional paid-in capital. The $85,714 of discount previously amortized is not reversed.

The guidance in ASC 470-20-55-17 implies that the entity made the following cumulative entries between the date of issuance and the date the intrinsic value was remeasured (if the convertible instrument was a debt instrument):

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>85,714</td>
</tr>
<tr>
<td>Discount</td>
<td>85,714</td>
</tr>
</tbody>
</table>

The conversion feature is no longer beneficial after the conversion price adjustment because the adjusted conversion price ($10) equals the commitment-date stock price ($10). Accordingly, the entity reverses the remaining unamortized discount (see Section 7.5.2):

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC (BCF)</td>
<td>342,857</td>
</tr>
<tr>
<td>Discount</td>
<td>342,857</td>
</tr>
</tbody>
</table>

7.5.3.2 Indeterminable Number of Incremental Shares

ASC 470-20

35-1 If the terms of a contingent conversion option do not permit an issuer to compute the number of shares that the holder would receive if the contingent event occurs and the conversion price is adjusted, an issuer shall wait until the contingent event occurs and then compute the resulting number of shares that would be received pursuant to the new conversion price. The number of shares that would be received upon conversion based on the adjusted conversion price would then be compared with the number that would have been received before the occurrence of the contingent event. The excess number of shares multiplied by the commitment date stock price equals the incremental intrinsic value that results from the resolution of the contingency and the corresponding adjustment to the conversion price. That incremental amount shall be recognized when the triggering event occurs. Example 5 (see paragraph 470-20-55-22) illustrates the application of this guidance.

Sometimes, the terms of a conversion feature do not permit the issuer to calculate the number of shares the holder would receive upon conversion before the occurrence of the contingent event (e.g., if the conversion price is down-round protected). In this case, the issuer computes the number of shares that it will deliver once the event occurs (unless the conversion feature represents a share-settled redemption feature; see Sections 2.4 and 7.2.3).
The guidance in ASC 470-20-35-1 suggests that if the triggering event occurs, the incremental intrinsic value will equal the product of (1) the commitment-date stock price ($S_0$) and (2) the excess number of shares that would be received upon conversion on the basis of the adjusted conversion price over the number that would have been received before the contingent event occurred ($n_1 - n_0$). Algebraically, this can be expressed as follows:

\[
\text{Incremental intrinsic value} = S_0 \times (\max ([n_1 - n_0], 0))
\]

However, we believe that this manner of calculating the incremental intrinsic value relies on two key assumptions: (1) the commitment-date stock price equals the conversion price before the adjustment (in a manner similar to ASC 470-20-55-23) and (2) the conversion feature is in-the-money on the basis of the adjusted conversion price.

The FASB staff has indicated that recognition of a beneficial conversion charge upon the adjustment of the conversion price is only required when the adjusted conversion price is reduced below the commitment-date fair value of the issuer's common stock. That is, a BCF exists only to the extent that the conversion feature is in-the-money (i.e., the adjusted conversion price is lower than the commitment-date stock price).

If the conversion feature is out-of-the-money (i.e., the conversion price exceeds the commitment-date stock price) both before and after the conversion price adjustment, no beneficial conversion charge is required. However, if the conversion feature is out-of-the-money before the conversion price adjustment but becomes in-the-money afterward (i.e., the reduced conversion price is below the commitment-date stock price), the entity should perform the following steps to calculate the amount of the beneficial conversion charge:

1. Compute the number of incremental shares to be issued as the difference between (a) the number of shares that would be issued upon conversion on the basis of the reduced conversion price and (b) the number of shares that would have been issued upon conversion had the conversion price been equal to the commitment date stock price (i.e., not the number of shares that would have been issued on the basis of the prior conversion price).

2. Multiply the number of incremental shares by the commitment date stock price.

If, on the basis of the commitment-date stock price, the conversion feature is in-the-money both before and after the conversion price adjustment and the conversion price is further reduced, an additional beneficial conversion charge is required. In that circumstance, the number of incremental shares to be issued as a result of the conversion price adjustment is computed in a manner consistent with ASC 470-20-35-1 as the difference between (1) the number of shares that would be received upon conversion on the basis of the reduced conversion price and (2) the number of shares that would be received upon conversion on the basis of the conversion price before the reduction. The incremental beneficial conversion charge is again computed by multiplying the number of incremental shares by the commitment-date stock price. However, the beneficial conversion charge(s) cannot be greater than either (1) the initial proceeds received (or allocated) from issuing the convertible instrument or (2) the current carrying amount of the instrument.
Example 7-20

Conversion Price Adjustment Based on Dividends

Company S issues $1 million of convertible debt with an initial conversion price of $27 per common share as of the commitment date, at which time the fair value of S’s common shares is $25. There are no embedded derivatives that require bifurcation under ASC 815, and the convertible debt is not subject to the CCF guidance in ASC 470-20.

The convertible debt indenture stipulates that if S declares a dividend on common stock greater than $1.00 per common share, the conversion price automatically adjusts downward on the basis of the following formula:

\[ \text{New conversion price} = \text{old conversion price} - (4 \times (\text{dividend per share} - $1.00)) \]

Because the convertible debt terms require an adjustment to reduce the conversion price upon the occurrence of a contingent event (i.e., the declaration of a dividend greater than $1.00), S should consider whether it must recognize a contingent BCF if that event occurs. However, S would recognize a BCF as of the date the contingent event occurs only if the adjusted conversion price is considered beneficial to the holder under ASC 470-20 (i.e., if the adjusted conversion price is less than the fair value of the shares as of the commitment date).

In accordance with ASC 470-20-35-1, because S cannot determine the number of shares that the convertible debt investor would receive until the occurrence of the contingent event, the value of the BCF, if any, would equal the product of (1) the number of incremental shares issuable under the adjusted conversion price and (2) the fair value of the shares as of the commitment date.

If, after the commitment date, S declares a dividend of $1.25, it would not need to recognize a BCF because the adjusted conversion price of $26 (calculated as $27 – [4 × ($1.25 – $1.00)]) is greater than the commitment-date fair value of the common shares, $25.

However, if, after the commitment date, S instead declares a dividend of $1.75, it would recognize a BCF because the adjusted conversion price of $24 (calculated as $27 – [4 × ($1.75 – $1.00)]) is lower than the fair value of the common shares as of the commitment date ($25). The value of the BCF is calculated in the table below:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares due at new conversion price ($24)</td>
<td>41,667</td>
<td>$1,000,000 ÷ $24</td>
</tr>
<tr>
<td>Shares due at the lower of the old conversion price ($27) and the fair value of the shares on the commitment date ($25)</td>
<td>40,000</td>
<td>$1,000,000 ÷ $25</td>
</tr>
<tr>
<td>Incremental shares</td>
<td>1,667</td>
<td>41,667 – 40,000</td>
</tr>
<tr>
<td>Amount of BCF</td>
<td>$41,675</td>
<td>$1,667 × $25</td>
</tr>
</tbody>
</table>

On the basis of the calculations indicated above, S would record the BCF arising from the conversion price adjustment (to $24) as follows:

Debt discount 41,675
Equity — APIC 41,675
7.5.3.2.1 Down-Round Protection

**ASC Master Glossary**

**Down Round Feature**

A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

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**ASC 470-20**

**35-4** A contingent conversion feature that will reduce (reset) the conversion price if the fair value of the underlying stock declines after the commitment date to or below a specified price is a beneficial conversion option if that specified price is below the fair value of the underlying stock at the commitment date. This is the case even if both of the following conditions exist:

a. The initial active conversion price is equal to or greater than the fair value of the underlying stock at the commitment date.

b. The contingent conversion price is greater than the then fair value of the underlying stock at the future date that triggers the adjustment to the conversion price.

A beneficial conversion amount shall be recognized for such a beneficial conversion option when the reset occurs.

**35-5** Example 4A (see paragraph 470-20-55-19A) illustrates the application of this guidance.

Convertible debt instruments often contain down-round price protection provisions that entitle the holders to a reduction in the instruments’ conversion price if future convertible securities or other equity or equity-linked instruments are issued with lower prices (see Section 4.3.7.2 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*). If there is a reduction in the conversion price in accordance with a down-round feature and (1) the conversion feature is not required to be accounted for as a derivative instrument in accordance with ASC 815 and (2) the instrument is not subject to the CCF guidance in ASC 470-20, the issuer should evaluate whether the recognition of a contingent BCF is necessary when a conversion price adjustment is triggered by a down-round feature. Recognition of a contingent BCF is required if the reduced effective conversion price is less than the commitment-date fair value of the issuer’s common stock.
Example 7-21

Contingent BCF for Down-Round Feature

Company ABC issues 100 units of convertible debt securities for $100 per security, resulting in total proceeds of $10,000. Each security is convertible into one share of common stock; thus, the conversion price is $100. At the time the debt is issued (the commitment date), the fair value of ABC's common stock is $10 per share. The convertible debt contains a down-round protection provision that resets the conversion price to that of a future round of financing, if lower.

One year after the issuance of the convertible debt, ABC issues Series A convertible preferred stock for $50 per share. Each share is convertible into one share of common stock. At the time the convertible preferred stock is issued, the common stock's fair value is $7 per share. Upon the issuance of the stock, the conversion price of the convertible debt is adjusted under the down-round protection provision to $50 so that each convertible debt security is then convertible into two shares of common stock instead of one.

The reduction in the conversion price does not result in a requirement for ABC to recognize a beneficial conversion charge because the adjusted conversion price of $50 is greater than the common stock's fair value of $10 as of the commitment date.

Two years after the issuance of the Series A convertible preferred stock, ABC issues a second round of convertible preferred stock for $4 per share. Each share is convertible into one share of common stock. At the time the additional convertible preferred stock is issued, the common stock's fair value is $3 per share. Upon the issuance of the additional stock, the conversion price of the convertible debt is adjusted under the down-round protection provision to $4 so that each convertible debt security is then convertible into 25 shares of common stock.

As a result of the second reduction in the conversion price, ABC must record a beneficial conversion charge because the adjusted conversion price of $4 is less than the $10 fair value of the common stock as of the commitment date. The beneficial conversion charge is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of common shares issuable at a conversion price of $4</td>
<td>$4 × (100 units × 25 common shares) = $10,000</td>
</tr>
<tr>
<td>Less: Number of common shares issuable at a conversion price of $10</td>
<td>$10 × (100 units × 10 common shares) = $1,000</td>
</tr>
<tr>
<td>Incremental common shares</td>
<td>1,500</td>
</tr>
<tr>
<td>Multiplied by the fair value of common stock as of the commitment date</td>
<td>$10</td>
</tr>
<tr>
<td>Beneficial conversion charge</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

In accordance with ASC 470-20-35-7, ABC would recognize the amortization of the discount in the convertible debt created by the beneficial conversion charge as an increase in interest cost.

Note that an entity would not analyze a conversion feature that economically represents a share-settled redemption feature as a contingent BCF (see Section 7.2.3). A share-settled redemption feature differs from a conversion feature with down-round protection because the latter type of conversion feature has a fair value that varies on the basis of changes in the issuer's stock price.
Example 7-21A

Share-Settled Redemption Feature
An entity issues a debt instrument with a principal amount of $10 million that is automatically converted into the issuer’s equity shares upon an IPO. The conversion price is the lower of (1) 80 percent of the stock price in the IPO or (2) $50. Although the conversion price is reduced to the IPO price if the IPO price is less than $50, this potential adjustment is not a down-round feature that should be evaluated as a contingent BCF because the associated settlement has a monetary value equal to a fixed monetary amount ($10,000,000 ÷ 0.80 = $12,500,000). Instead, an entity should evaluate this share-settled redemption feature in a manner similar to a put or call option embedded in a debt host contract to determine whether the feature must be separated as a derivative under ASC 815-15 (see Section 2.4).

Example 7-21B

Down-Round Feature
An entity issues a 10-year convertible debt instrument with a principal amount of $10 million. The conversion price is $50. If an IPO occurs and the IPO price is less than $50, the conversion price is reduced to the IPO price. The holder is not required to convert the debt upon an IPO; it can continue to hold the debt and elect to convert it at a later date. If this conversion feature is otherwise within the scope of the BCF guidance in ASC 470-20, the potential adjustment to the conversion price upon an IPO is a down-round feature that should be evaluated as a contingent BCF. This is because the conversion feature has a monetary value that varies on the basis of the changes in the issuer’s stock price both before and after the IPO.

7.5.3.2.1.1 Illustrations — Application of Contingent BCF Guidance to Down-Round Feature

ASC 470-20

Example 5: Contingent Conversion Option Does Not Permit Calculation of Shares Received on Conversion

55-22 This Example illustrates the guidance in paragraph 470-20-35-1.

55-23 Assume Entity A issues for $1 million a convertible debt instrument that is convertible into 100,000 shares of Entity A common stock ($10 conversion price) when the fair value of the stock is $10. This instrument provides that if Entity A subsequently issues common stock at a price less than $10, the conversion price adjusts to 90 percent of that subsequent issue price.

55-24 If Entity A subsequently issues common stock at a price of $8 per share, the holder’s conversion price adjusts to $7.20 ($8 × 90%) and the holder now would receive 138,888 shares ($1 million ÷ $7.20) upon conversion, an increase of 38,888 shares from the 100,000 shares that would have been received before the occurrence of the contingent event. The incremental intrinsic value that results from triggering the contingent option is $388,888 — calculated as 38,888 shares × $10 stock price at the commitment date or, alternatively, ($1 million ÷ $7.20) × ($10 - $7.20) — and would be recognized upon the subsequent issuance of common stock at the $8 per share price. The accretion of this discount would be required from the date the common stock was subsequently issued at $8 per share in accordance with this Subtopic.

Example 5 illustrates the application of the contingent BCF guidance to a down-round feature. The guidance in ASC 470-20-55-24 implies that Entity A makes the following entry when the contingent BCF is triggered:

Debt discount 388,888
Equity — APIC (BCF) 388,888
In the calculation of intrinsic value in Example 5 in ASC 470-20-55-22 through 55-24, it is assumed that (1) the original conversion price equals the commitment-date stock price (i.e., the conversion feature was at-the-money on the commitment date) and (2) the adjusted conversion price is lower than the commitment-date stock price (i.e., the adjusted conversion feature is in-the-money on the basis of the commitment-date stock price). If, instead, the conversion feature is out-of-the-money on the commitment date (i.e., the original conversion price exceeded the commitment-date stock price) and the adjusted conversion feature is in-the-money on the basis of the commitment-date stock price, the issuer may compute the incremental number of shares as the difference between (1) the number of shares that it would have issued upon conversion had the conversion price been equal to the commitment-date stock price (i.e., not the number of shares that it would have issued on the basis of the prior conversion price) and (2) the number of shares it would issue at the adjusted conversion price. If the adjusted conversion feature is out-of-the-money on the basis of the commitment-date stock price, no incremental BCF should be recognized.

Further, an implicit assumption in Example 5 is that the conversion feature is not required to be bifurcated as a derivative instrument under ASC 815-15-25-1 since that would have caused the instrument to fall outside the scope of the BCF guidance in ASC 470-20.

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**ASC 470-20**

*Example 7: Beneficial Conversion Features or Contingently Adjustable Conversion Ratios*

**55-28** The following Cases illustrate the guidance for beneficial conversion features or contingently adjustable conversion ratios for convertible securities: 

- e. Convertible instrument contains fixed terms that change based on a future event (Case E).
- f. Conversion is dependent on a future event and terms are variable (Case F).

**Case E: Convertible Instrument Containing Fixed Terms That Change Based on a Future Event**

**55-49** This Case illustrates the guidance in paragraphs 470-20-35-2 through 35-3 and 470-20-35-7.

**55-50** This Case has the following assumptions:

- a. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance
- b. Convertible at date of issuance
- c. Convertible at 80 percent of stock price at commitment date (that is, $40)
- d. Fair value of common stock at commitment date equals $50 per share and if there is an initial public offering, the conversion feature adjusts to the lesser of $30 or 80 percent of the initial public offering price.

**55-51** This Case has the following assumptions:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value at commitment date</td>
<td>$ 50</td>
</tr>
<tr>
<td>Conversion price at commitment date</td>
<td>$ 40</td>
</tr>
<tr>
<td>Intrinsic value of basic beneficial conversion feature at commitment date</td>
<td>$ 250,000(^{(a)})</td>
</tr>
<tr>
<td>Conversion price at contingency resolution</td>
<td>unknown</td>
</tr>
<tr>
<td>Intrinsic value of contingent beneficial conversion feature at commitment date</td>
<td>unknown</td>
</tr>
</tbody>
</table>

\(^{(a)}\) \((1,000,000 \div 40) \times (50 - 40)\).
ASC 470-20 (continued)

55-52 This instrument includes a basic beneficial conversion feature that is not contingent upon the occurrence of a future event and a contingent beneficial conversion feature. Accordingly, the intrinsic value of the basic beneficial conversion feature of $250,000 is calculated at the commitment date and recorded at the issuance date. Because the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

55-54 Entry at date of issuance.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Debt discount</td>
<td>250,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>250,000</td>
</tr>
</tbody>
</table>

55-54A The terms of the convertible debt instrument do not permit the number of shares that would be received upon conversion if an initial public offering occurs to be calculated at the commitment date.

Case F: Conversion Dependent on a Future Event and Terms Are Variable

55-55 This Case illustrates the guidance in paragraph 470-20-35-2 through 35-3.

55-56 This Case has the following assumptions.
   a. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance
   b. Convertible at date of issuance
   c. Convertible at 80 percent of stock price at commitment date (that is, $40)
   d. Fair value of common stock at commitment date equals $50 per share
   e. If the stock price increases at least 15 percent one year after an initial public offering, the conversion feature adjusts to 65 percent of the fair value of the common stock 1 year after the initial public offering.

55-57 The calculation is as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value at commitment date</td>
<td>$50</td>
</tr>
<tr>
<td>Conversion price at commitment date</td>
<td>$40</td>
</tr>
<tr>
<td>Conversion price at contingency resolution</td>
<td>unknown</td>
</tr>
<tr>
<td>Intrinsic value of basic beneficial conversion feature at commitment date</td>
<td>$250,000^1</td>
</tr>
<tr>
<td>Intrinsic value of contingent beneficial conversion feature at commitment date</td>
<td>unknown</td>
</tr>
</tbody>
</table>

^1 (1,000,000 ÷ 40) × (50 – 40).

55-58 The amount of the beneficial conversion feature is measured using the terms of the beneficial conversion feature that are operative at issuance, that is, the 20 percent discount. The intrinsic value of that beneficial conversion feature ($250,000) is calculated at the commitment date and recorded at the issuance date. Because the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.
# Derecognition

## Conversions

**ASC 470-20**

40-1 For instruments with beneficial conversion features all of the unamortized discount remaining at the date of conversion shall be recognized immediately at that date as interest expense or as a dividend, as appropriate, including both of the following amounts:

a. The discount originated by the beneficial conversion option accounting under paragraph 470-20-25-5

b. The discount from an allocation of proceeds under this Subtopic to other separable instruments included in the transaction.

40-2 If a convertible debt instrument containing an embedded beneficial conversion feature is converted, and the amount of discount amortized exceeds the amount the holder realized because conversion occurred at an earlier date, no adjustment shall be made to amounts previously amortized.

If a convertible debt instrument with a separated BCF is converted in accordance with its original conversion terms, all of the remaining unamortized discount (both the discount from the allocation of proceeds to other separable instruments included in the transaction and the discount originated by the BCF) as of the conversion date is recognized immediately on that date. (Note that this is different from the treatment of any unamortized discount on traditional convertible debt, which is credited to equity; see Section 4.5.2.) For a convertible debt instrument, the amount is recognized as interest expense (Dr: Interest expense; Cr: Debt discount).

If conversion occurs under the original terms of the debt, the adjusted carrying amount (i.e., the previous net carrying amount adjusted for the remaining unamortized discount as of the conversion date) is credited to equity to reflect the shares issued. If the conversion represents an induced conversion as described in ASC 470-20-40-13 (see Section 4.5.4), the issuer also recognizes an inducement expense (or dividend) equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of the securities issuable in accordance with the original conversion terms. In this circumstance, the sum of the adjusted carrying amount and the inducement expense would be credited to equity to reflect the shares issued.
This accounting does not apply to any of the following:

- A conversion that represents a TDR (see Section 4.5.7).
- A conversion upon the issuer's exercise of a call option if the feature was not substantive at issuance. Although a noncontingent BCF generally would be considered substantive at issuance, the issuer should evaluate a contingent BCF to determine whether it was nonsubstantive (see Section 4.5.3). If the conversion feature was nonsubstantive at issuance and conversion occurs upon the issuer's exercise of a call option, the issuer should apply extinguishment accounting (see Section 7.6.2 below).
- A settlement of debt that uses a variable number of the issuer's equity shares equal in value to the amount of the debt.
- A conversion that occurs in accordance with the terms of a share-settled redemption feature (see Section 2.4).
- An exchange of debt into the shares of a third party (see Section 2.7).

See Appendix B for a discussion of the accounting upon conversion for situations in which the conversion feature was separated as a derivative instrument under ASC 815-15 and conversion occurs in accordance with the original terms.

### 7.6.2 Extinguishments

For a discussion of the circumstances in which a conversion or exchange of convertible debt for the issuer's equity shares should be accounted for as an extinguishment, see Section 4.5.5. Below is a discussion of the accounting for an extinguishment of convertible debt that contains a separated BCF.

**ASC 470-20**

| 40-3 If a convertible debt instrument containing an embedded beneficial conversion feature is extinguished before conversion, the amount of the reacquisition price to be allocated to the repurchased beneficial conversion feature shall be measured using the intrinsic value of that conversion feature at the extinguishment date. The residual amount, if any, would be allocated to the convertible security. Thus, the issuer shall record a gain or loss on extinguishment of the convertible debt security. For guidance on classification of any gain or loss from extinguishment, see Section 470-50-45. |

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**EITF Issue 00-27 (Nonauthoritative Text)**

Issue 12 — If a convertible instrument that included a beneficial conversion option . . . is extinguished prior to its stated maturity date, how [the BCF guidance] should be applied to the reacquisition of the embedded conversion option.

Issue 12(a) — Whether it is appropriate to allocate a portion of the reacquisition price to the conversion option based on the intrinsic value of that option at the extinguishment date if no separate accounting for the conversion option under [the BCF guidance] has occurred.

34. The Task Force reached a tentative conclusion that no portion of the reacquisition price should be allocated to the conversion option if that option had no intrinsic value required to be accounted for under [the BCF guidance].

Issue 12(b) — How the requirement to allocate a portion of the reacquisition price to the beneficial conversion option for convertible debt should be applied if the intrinsic value of that option at the date of extinguishment is greater than the originally measured intrinsic value.
EITF Issue 00-27 (Nonauthoritative Text) (continued)

35. The Task Force reached a tentative conclusion that [the BCF guidance] does not provide for a different measurement of the amount of the reacquisition price that is allocated to the reacquisition of the conversion option if the intrinsic value of the conversion option is greater at the extinguishment date than the amount measured at the commitment date. In other words, the amount of the reacquisition price allocated to the conversion option is always calculated based on the option's intrinsic value at the extinguishment date, which could result in a reduction in additional paid-in capital that exceeds the amount recorded in additional paid-in capital for the beneficial conversion option when the instrument was issued. . . .

If a convertible debt instrument with a recognized BCF is extinguished instead of being converted, a portion of the consideration paid by the issuer to reacquire the instrument is allocated to the BCF; that is, a portion of the reacquisition price is treated as a repurchase of the BCF. Unless ASC 470-20-30-8 applies (see below), the amount allocated to the BCF is the intrinsic value of the conversion feature on the extinguishment date, which is computed by multiplying (1) any excess of the conversion-date fair value of the common stock or other securities into which the instrument is convertible over the effective conversion price by (2) the number of shares into which the instrument is convertible (see Section 7.3.2). The resulting amount is debited to APIC, with no gain or loss recognized. (ASC 260-10-S99-2 does not apply to the settlement of the equity component for a convertible debt instrument that permits conversion into the issuer's common stock.) The residual amount of the consideration paid is allocated to the reacquisition of the debt instrument; the difference between this amount and the net carrying amount is the debt extinguishment gain or loss.

Example 7-22

Reacquisition of Convertible Debt With a BCF

Issuer A buys back outstanding convertible debt that has a current net carrying amount of $95 for $100 in cash. At issuance, the issuer recognized a BCF of $2 related to the debt. However, the intrinsic value of the conversion feature computed on the basis of the current share price is $7. Issuer A records the following journal entry upon the reacquisition of the debt:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>95</td>
</tr>
<tr>
<td>Equity — APIC (BCF)</td>
<td>7</td>
</tr>
<tr>
<td>Cash</td>
<td>100</td>
</tr>
<tr>
<td>Debt extinguishment gain</td>
<td>2</td>
</tr>
</tbody>
</table>

In a manner consistent with the EITF's tentative conclusions on Issue 12 of EITF Issue 00-27, this guidance (1) is appropriate to apply even if the extinguishment-date intrinsic value exceeds the commitment-date intrinsic value and (2) is not applied if the instrument did not contain a recognized BCF as of the conversion date. Accordingly, upon the extinguishment of a convertible debt instrument that contained a contingent BCF that had not been triggered as of the extinguishment date, no portion of the amount of consideration paid would be allocated to the reacquisition of the contingent BCF. However, we believe that if the BCF's intrinsic value exceeds the portion of the proceeds allocated to the convertible instrument upon initial recognition, the amount of the reacquisition price that should be allocated to the intrinsic value would be limited by the amount initially assigned to the BCF in accordance with ASC 470-20-30-8. In addition, we believe that the BCF's extinguishment-date intrinsic value cannot exceed the total proceeds related to the extinguishment.
Apart from the allocation of a portion of the reacquisition price to the BCF, a debt extinguishment gain or loss on a convertible debt that contains a BCF is determined in a manner consistent with the approach for traditional convertible debt (see Section 4.5.5).

### 7.6.2.1 Illustration — Extinguishment of Convertible Debt With a BCF

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 7: Beneficial Conversion Features or Contingently Adjustable Conversion Ratios</strong></td>
</tr>
</tbody>
</table>

55-28 The following Cases illustrate the guidance for beneficial conversion features or contingently adjustable conversion ratios for convertible securities: . . .

  g. Extinguishment of convertible debt that includes a beneficial conversion feature (Case G).

**Case G: Extinguishment of Convertible Debt That Includes a Beneficial Conversion Feature**

55-61 This Case illustrates the guidance in paragraph 470-20-40-3.

55-62 Both of the following conditions exist at the commitment date:

  a. Proceeds for sale of zero coupon convertible debt are $100.
  b. Intrinsic value of beneficial conversion feature is $90.

55-63 At the commitment date, the issuer records $90 as discount on the debt with the offsetting entry to additional paid-in-capital. The remainder ($10) is recorded as debt and is accreted to its full face value of $100 over the period from the issuance date until the stated redemption date of the instrument (3 years). The debt is subsequently extinguished one year after issuance.

55-64 All of the following conditions exist at the extinguishment date:

  a. The reacquisition price is $150.
  b. The intrinsic value of the beneficial conversion feature at the extinguishment date is $80.
  c. The carrying value of debt is $22.

The net carrying value of the debt one year after issuance is calculated using the effective interest method to amortize the debt discount over three years.

55-65 At the date of extinguishment, the extinguishment proceeds should first be allocated to the beneficial conversion feature ($80). The remainder ($70) is allocated to the extinguishment of the convertible security.

55-66 Entry to record the extinguishment.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$22</td>
</tr>
<tr>
<td>Equity (paid-in capital)</td>
<td>80</td>
</tr>
<tr>
<td>Loss on extinguishment</td>
<td>48</td>
</tr>
<tr>
<td>Cash</td>
<td>$150</td>
</tr>
</tbody>
</table>
7.6.3 Modifications and Exchanges

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-16</strong> The issuer shall not recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon a modification or exchange of convertible debt instruments in a transaction that is not accounted for as an extinguishment.</td>
</tr>
</tbody>
</table>

If a convertible debt instrument is modified or exchanged for another instrument, the issuer applies ASC 470-50 to determine whether the modification or exchange should be accounted for as a modification or extinguishment of the original instrument (see Section 4.5.6) unless it is a TDR that should be evaluated under ASC 470-60 (see Section 4.5.7).

ASC 470-50 does not explicitly address whether and, if so, how the separation of a BCF affects an issuer’s assessment of whether the terms of a convertible debt instrument that has been modified or exchanged are substantially different from the terms of the original instrument. We believe that it is reasonable for an entity applying the 10 percent cash flow test in ASC 470-50-40-10 to discount the cash flows by using an original effective interest rate that reflects the separation of a BCF (i.e., the discount rate is the effective interest rate of the original debt instrument after separation of the BCF; see Section 7.4). In the determination of whether the change in an embedded conversion option’s fair value is at least 10 percent of the original debt instrument’s carrying amount immediately before the modification or exchange, it is acceptable to add back to the carrying amount any discount created by a BCF since the purpose is to assess the significance of the change in fair value relative to the instrument as a whole. In other words, this test is performed as if the convertible debt instrument had never been separated into component parts (i.e., it requires the use of a pro forma net carrying amount of the convertible debt instrument as if separation had not occurred).

If the exchange or modification is accounted for as an extinguishment because the new terms are substantially different from those of the original instrument, a portion of the consideration paid by the issuer (including the fair value of the new debt instrument) is allocated to the BCF before the extinguishment gain or loss is computed. The amount allocated to the BCF is the intrinsic value of the conversion feature on the extinguishment date (see Section 7.6.2).

If the exchange or modification is accounted for as a modification under ASC 470-50 because the new terms are not substantially different from those of the original instrument, the issuer is precluded from recognizing a new BCF or reassessing an existing BCF. Instead, the issuer applies the guidance in ASC 470-50-40-14 and 40-15 to account for a change in the fair value of the conversion feature.

7.6.4 Reclassifications

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-8</strong> This guidance applies to convertible instruments in which the beneficial conversion feature terminates after a specified time period.</td>
</tr>
</tbody>
</table>

**35-9** If a convertible instrument is in the form of an equity share and the shares are required to be redeemed once the conversion feature expires, the financial instrument becomes a liability under the guidance in Topic 480 upon expiration of the conversion and paragraph 480-10-30-2 requires the issuer to reclassify an instrument that becomes mandatorily redeemable as a liability, measured initially at fair value with a corresponding reduction of equity (no gain or loss is to be recognized). That may entail an adjustment to paid-in capital if, upon reclassification, the fair value of the liability differs from the carrying amount of the previously convertible instrument. That instrument would be subsequently measured under the provisions of Topic 480.
If the terms of a convertible instrument in the legal form of an outstanding share (e.g., a convertible preferred share) contain a mandatory redemption date, the share may have to be reclassified from equity to a liability if or when the conversion feature expires. ASC 480-10-25-7 requires a financial instrument for which redemption is conditional (e.g., an instrument that is mandatorily redeemable unless the holder exercises a conversion feature) to be reclassified as a liability if redemption becomes certain to occur (e.g., because an embedded conversion feature has expired). Under ASC 480-10, the reclassified instrument would initially be measured at fair value (see Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*).

### Example 7-23

**Mandatorily Redeemable Convertible Preferred Stock**

ASC 480-10-55-11 contains an example of mandatorily redeemable convertible preferred stock. The holder has the right to convert the preferred stock into a fixed number of shares of common stock during the first 10 years. If the holder does not exercise the conversion feature, the instrument becomes mandatorily redeemable on a stated redemption date in 30 years. Because redemption is not certain to occur during the first 10 years, the instrument is not initially required to be classified as a liability under ASC 480-10 (provided that the conversion feature is substantive). However, the share must be reclassified as a liability as of the date the conversion feature expires in 10 years because redemption becomes certain to occur at that point.

### 7.6.5 Bifurcation of a Conversion Option

An entity that has issued a convertible debt instrument that contained a recognized initial or contingent BCF may be required to subsequently bifurcate the embedded conversion option because of a change in facts and circumstances — for example, if the issuer undertakes an IPO of its common stock and, as a result, the embedded conversion option meets the net settlement condition. The example below illustrates the accounting in this situation.

### Example 7-24

**Bifurcation of Conversion Option in Convertible Debt Instrument With a BCF**

XYZ Company issued a four-year $10 million par value convertible debt instrument. The embedded conversion option was not separated at issuance because XYZ was a nonpublic company and the underlying shares were not readily convertible to cash. The convertible debt instrument contained a $4 million BCF on issuance, which reflected the difference between the conversion price of $7.14 and the $10 commitment-date fair value of XYZ common stock. On the issuance date, the fair value of the conversion option was $5 million.

At the end of year 2, XYZ undertakes an IPO of its common stock (i.e., the common stock is now readily convertible to cash) and, as a result, separates the embedded conversion option because it does not meet the exception in ASC 815-10-15-74(a). On that date, the following amounts pertained to the convertible debt instrument:

| Carrying amount of the debt instrument | $ 8,000,000 |
| Fair value of XYZ common stock (per share) | $ 12 |
| Fair value of the conversion option | $ 7,000,000 |
| Intrinsic value of the conversion option | $ 6,800,000 |

For simplicity, no deferred debt issuance costs, issue premiums, or discounts are considered. In addition, straight-line amortization is assumed.
Example 7-24 (continued)

As of the date the embedded conversion option requires separation from the host debt contract, XYZ should initially recognize a liability for the option at its fair value in accordance with ASC 815-15-30-2. In addition, XYZ should account for the extinguishment of the BCF in a manner similar to the accounting for a reacquisition of such a feature (see Section 7.6.2). However, for the reasons discussed below, the amount allocated to the reacquisition of the BCF should equal its intrinsic value on the issuance date of the convertible debt instrument. XYZ Company records the following journal entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible debt liability</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Equity — APIC</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Conversion option liability</td>
<td>7,000,000</td>
</tr>
</tbody>
</table>

After the journal entry is recorded, the carrying amount of the host debt contract is $5 million. The total interest expense amortized into earnings equals $7 million ($2 million amortized before the separation of the embedded conversion option and $5 million amortized afterward). Consequently, the total amount of amortized interest equals the total amount that would have been amortized if a BCF had not existed on the original issuance date. The portion of the option's separation-date fair value that is subsequently amortized reflects the fact that the portion of the fair value that represents the issuance-date intrinsic value ($2 million) has already been amortized. The entire balance of the previously recorded APIC for the BCF is eliminated, which is appropriate since the embedded conversion feature continues to exist but is no longer classified in equity.

The accounting in the above example differs from the guidance in Issue 12 of EITF Issue 00-27 because Issue 00-27 discusses a convertible debt instrument that has been extinguished and, therefore, the accounting reflects such extinguishment (including situations in which the extinguishment occurs by a debtor that pays fair value for the convertible debt instrument and the BCF). An alternative view that would allocate an amount to the elimination of the BCF equal to the conversion option's intrinsic value on the date it is separated as an embedded derivative would result in a reduction of the host debt contract's carrying amount of only $200,000. In such a case, the carrying amount of the host debt contract would be $7.8 million and the total amortized interest expense would equal $4.2 million ($2 million amortized before separation of the embedded option and $2.2 million amortized afterward). Under this view, the issuer would thus be allowed to recognize a smaller total amortized interest expense than would have been recognized had the BCF never existed (irrespective of whether the embedded conversion option had been separated at inception or on the date of the IPO). Therefore, this alternative view would not be appropriate.

Given XYZ's facts and circumstances, the following alternative views would also be unacceptable:

- **An accounting method based on the debt host's hypothetical carrying amount if the conversion option had been separated on the issuance date** — It is not appropriate to record the reacquisition of the BCF so that the host carrying amount on the separation date would equal the amount that would have been recorded on that date if the conversion option had been separated since inception. The application of ASC 815-15 to the separation of an embedded derivative after the issuance of the hybrid financial instrument is not intended to result in a debt host contract amount that is the same as the amount that would have existed had the derivative been separated at inception.

- **Failure to account for the reacquisition of the BCF** — In some fact patterns, ignoring the reacquisition of the BCF could result in a total interest amortization that exceeds the proceeds received in the transaction, which would not be appropriate under ASC 470-20 or ASC 815.

- **Application of the fair value option in lieu of the separation of the embedded conversion option** — Because the separation of the embedded conversion option does not require the entire hybrid financial instrument to be recognized at fair value, the election of the fair value option under ASC 825-10 is not permitted. In XYZ's case, there were no modifications or exchanges of the convertible debt instrument that required extinguishment accounting.

The accounting described above will vary depending on the specific facts and circumstances.
Chapter 7 — Beneficial Conversion Features

7.7 Presentation and Disclosure

The classification of convertible debt that contains a BCF as current or noncurrent in a classified balance sheet and the presentation of issuance costs of such debt are governed by the same requirements as those that apply to traditional convertible debt (see Section 4.6).

For convertible debt instruments with BCFs, issuers apply the general presentation and disclosure guidance for convertible debt instruments (see Section 4.6). These disclosures include matters related to the intrinsic value of the conversion option.
Chapter 8 — Own-Share Lending Arrangements in Connection With Convertible Debt Issuance

8.1 Overview

ASC 470-20

05-12A An entity for which the cost to an investment banking firm (investment bank) or third-party investors (investors) of borrowing its shares is prohibitive (for example, due to a lack of liquidity or extensive open short positions in the shares) may enter into share-lending arrangements that are executed separately but in connection with a convertible debt offering. Although the convertible debt instrument is ultimately sold to investors, the share-lending arrangement is an agreement between the entity (share lender) and an investment bank (share borrower) and is intended to facilitate the ability of the investors to hedge the conversion option in the entity's convertible debt.

05-12B The terms of a share-lending arrangement require the entity to issue shares (loaned shares) to the investment bank in exchange for a nominal loan processing fee. Although the loaned shares are legally outstanding, the nominal loan processing fee is typically equal to the par value of the common stock, which is significantly less than the fair value of the loaned shares or the share-lending arrangement. Generally, upon maturity or conversion of the convertible debt, the investment bank is required to return the loaned shares to the entity for no additional consideration.

05-12C Other terms of a share-lending arrangement typically require the investment bank to reimburse the entity for any dividends paid on the loaned shares. Typically, the arrangement precludes the investment bank from voting on any matters submitted to a vote of the entity's shareholders to the extent the investment bank is the owner of the shares.

ASC 470-20 provides guidance on an issuer's accounting for equity-classified share-lending arrangements on its own shares that are executed in contemplation of a convertible debt issuance. In practice, an issuer may enter into such an arrangement to help ensure the successful completion of the convertible debt offering by facilitating investors' ability to economically hedge their exposure to the share price risk associated with the issuer's stock that is inherent in the convertible instrument.
Chapter 8 — Own-Share Lending Arrangements in Connection With Convertible Debt Issuance

Example 8-1

Own-Share Lending in Conjunction With Convertible Debt Issuance

Issuer A is issuing convertible debt. However, before agreeing to buy the debt, certain prospective investors would like to ensure that they can economically hedge their exposure to the share price risk related to A's stock that is associated with the embedded conversion option. Accordingly, the prospective investors enter into derivative contracts on the underlying shares (e.g., options, forwards, or total return swaps) with Bank B that offset the exposure related to the "long" position in A's stock that would result from the convertible debt investment. To economically hedge its own exposure from writing such derivatives, B borrows the underlying shares and sells them short in the market.

Because B cannot secure a sufficient number of underlying shares in the market (i.e., they are not readily available to market participants) or the price is too high, it borrows the underlying shares by entering into a share-lending arrangement directly with A. The terms of the arrangement require B to pay a nominal processing fee to A (e.g., the par value of the shares) that is significantly less than the agreement's fair value. Issuer A is motivated to enter into the agreement because the pricing and successful completion of the convertible debt offering depend on the investors' ability to enter into derivative contracts to hedge their equity price exposure, which in turn depends on B's ability to borrow the shares.

During the period in which the shares are on "loan," they are legally outstanding and the holder is legally entitled to any dividends paid on them, although it must reimburse A for such payments. Upon the conversion or maturity of the convertible debt, B must physically return the loaned shares to A for no consideration. If B defaults in returning the loaned shares, A is contractually entitled to a cash payment equal to the shares' fair value.

This chapter describes the scope of the guidance (Section 8.2 below), the initial and subsequent accounting (Sections 8.3 and 8.4), and specific presentation and disclosure considerations (Section 8.5) related to these types of arrangements.

8.2 Scope

The guidance on the issuer's accounting for own-share lending arrangements in ASC 470-20 applies to arrangements that have the following terms and characteristics:

- The issuer is lending its equity shares to the counterparty (i.e., it has issued its equity shares on loan).
- The issuer receives a nominal fee that is significantly less than the fair value of the shares and of the arrangement.
- The counterparty will return the loaned shares to the issuer on the arrangement's maturity date for no additional consideration. If the counterparty is unable to return the loaned shares, it may be required to reimburse the issuer in cash.
- The arrangement qualifies as equity under GAAP.
- The arrangement was executed in contemplation of a convertible debt issuance or other financing.

In evaluating whether the contract qualifies as equity under GAAP, the issuer should consider the requirements in ASC 480-10 and ASC 815-40.

Connecting the Dots

For a discussion of the evaluation of whether an own-share lending arrangement qualifies as equity under ASC 815-40, see Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity, in particular Sections 2.9, 4.3.5.11, and 5.2.3.6.
8.3 Initial Accounting

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-20A</td>
</tr>
<tr>
<td>30-26A</td>
</tr>
</tbody>
</table>

Own-share lending arrangements within the scope of this guidance (see Section 8.2) are initially recorded at fair value and recognized as a debt issuance cost with an offset to APIC in the issuer’s financial statement (i.e., Dr: Debt; Cr: Equity — APIC).

The terms of a share-lending arrangement entered into in contemplation of a convertible debt issuance typically require an entity to issue its common shares to a counterparty (e.g., the bank) in exchange for a nominal processing fee. The processing fee is significantly less than the fair value of the shares and is typically less than a market fee that would be charged in a share-lending arrangement that was not entered into in contemplation of a convertible debt issuance. To promote the issuance of the debt, the issuer may sometimes accept less than the market rate on the share-lending arrangement. The fair value of the share-lending arrangement will be determined on the basis of the difference between the contractual processing fee and a market-based fee that would typically be charged for lending such shares, adjusted as necessary to reflect the nonperformance risk of the share borrower.

**Example 8-2**

**Initial Accounting for Own-Share Lending Arrangement**

Issuer A issues convertible debt at par for cash proceeds of $250 million. The stated interest rate on the debt is 2.5 percent per annum. The debt is due five years from the issuance date and is convertible into A’s equity shares at the holder’s option. Issuer A determines that the convertible debt should be accounted for as traditional convertible debt under ASC 470-20 (see Chapter 4). Accordingly, the equity conversion option is not separately recognized as an equity component under ASC 470-20.

In contemplation of the convertible debt issuance, A executes a share-lending arrangement with Bank B to help ensure the successful completion of the debt offering, and A receives $100,000 for the arrangement (which is also the par amount of the shares issued). However, the fair value of the arrangement is $15 million. Issuer A evaluates the share-lending arrangement under ASC 470-20 and ASC 815-40 and determines that it qualifies as equity.

On the date that both the debt issuance and the share-lending arrangement occur, A makes the following journal entry:

<table>
<thead>
<tr>
<th>Cash</th>
<th>250,100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>235,000,000</td>
</tr>
<tr>
<td>Equity — APIC</td>
<td>15,000,000</td>
</tr>
<tr>
<td>Equity — shares</td>
<td>100,000</td>
</tr>
</tbody>
</table>
Chapter 8 — Own-Share Lending Arrangements in Connection With Convertible Debt Issuance

8.4 Subsequent Accounting

If it becomes probable that the counterparty to a share-lending arrangement will default, the issuer of the share-lending arrangement shall recognize an expense equal to the then fair value of the unreturned shares, net of the fair value of probable recoveries, with an offset to additional paid-in capital. The issuer of the share-lending arrangement shall remeasure the fair value of the unreturned shares each reporting period through earnings until the arrangement consideration payable by the counterparty becomes fixed. Subsequent changes in the amount of the probable recoveries should also be recognized in earnings.

Unless an issuer elects to account for debt arising from an own-share lending arrangement at fair value under the fair value option in ASC 825-10 (see Section 2.5), it uses the effective interest method to amortize any debt discount (or reduced premium) that is created by recognizing the arrangement. The amount recognized in equity is not remeasured as long as (1) the share-lending arrangement qualifies as equity under ASC 815-40 and (2) it is not probable that the counterparty to the share-lending arrangement will default in returning the loaned shares (or an equivalent amount of consideration).

If it becomes probable that the counterparty to the share-lending arrangement will default in returning the loaned shares (or an equivalent amount of consideration), the issuer must recognize an expense equal to the fair value of the unreturned shares adjusted for the fair value of any probable recoveries. The offsetting entry for the expense is to APIC (i.e., Dr: Loss; Cr: Equity — APIC). The EITF stated the following related to Issue 09-1 at its June 18, 2009, meeting:

Some Task Force members observed that equity-classified instruments do not generally result in expense charges. However, the Task Force concluded that an expense was appropriate in this situation because it relates to a counterparty default and not changes in the entity’s share price.

In other words, the EITF determined that even though the share-lending arrangement is classified in equity, it is appropriate to record an expense because the issuer incurs a loss from the counterparty’s failure to satisfy its obligation to return the loaned shares. Under the contractual terms of the instrument, the issuer should have received the shares back (or an equivalent amount of consideration), but instead it received no value or something of lesser value because of the counterparty’s default.

The amount of the loss (i.e., the fair value of the unreturned shares adjusted for probable recoveries) is remeasured each period (e.g., for changes in the fair value of the unreturned shares) until the consideration payable becomes fixed. The issuer recognizes changes in the amount of the loss in earnings with an offset to APIC.

8.5 Presentation and Disclosure

8.5.1 Presentation

As noted in Section 8.3, own-share lending arrangements within the scope of this guidance (see Section 8.2) are initially recognized as a debt issuance cost, with an offset to APIC. Under ASC 835-30-45-1A, debt issuance costs are reported as a direct deduction from the par amount of the debt on the face of the balance sheet. They are not classified as a deferred charge.
8.5.2 Earnings per Share

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-2A Loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs, at which time the loaned shares would be included in the basic and diluted earnings-per-share calculation. If dividends on the loaned shares are not reimbursed to the entity, any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to the loaned shares shall be deducted in computing income available to common shareholders, in a manner consistent with the two-class method in paragraph 260-10-45-60B.</td>
</tr>
</tbody>
</table>

ASC 470-20 contains EPS guidance for own-share lending arrangements executed in contemplation of a convertible debt offering or other financing. Under this guidance, loaned shares are excluded from EPS unless the counterparty to the share-lending arrangement defaults on its obligation to return the loaned shares (or an equivalent amount of consideration). If the counterparty defaults, the shares are included in both basic and diluted EPS. (Note that in ASC 470-20-45-2A, the threshold for including the loaned shares in EPS is the counterparty’s default, whereas in ASC 470-20-35-11A, the threshold for recognizing a loss is that it is probable that the counterparty will default.)

In practice, own-share lending arrangements often require the counterparty to reimburse the issuer for any dividends paid on the loaned shares. If the counterparty does not reimburse the issuer for such dividends, however, the issuer must deduct the corresponding amount and any participation right in undistributed earnings from income available to common stockholders.

Connecting the Dots

For a discussion of the presentation and disclosure of EPS related to own-share lending arrangements, see Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share, in particular Sections 3.3.2.8, 4.8.3.5, 5.3.3.9, and 8.5.

8.5.3 Disclosure

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-2A An entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing shall disclose all of the following. The disclosures must be made on an annual and interim basis in any period in which a share-lending arrangement is outstanding.</td>
</tr>
<tr>
<td>a. A description of any outstanding share-lending arrangements on the entity’s own stock</td>
</tr>
<tr>
<td>b. All significant terms of the share-lending arrangement including all of the following:</td>
</tr>
<tr>
<td>1. The number of shares</td>
</tr>
<tr>
<td>2. The term</td>
</tr>
<tr>
<td>3. The circumstances under which cash settlement would be required</td>
</tr>
<tr>
<td>4. Any requirements for the counterparty to provide collateral.</td>
</tr>
<tr>
<td>c. The entity’s reason for entering into the share-lending arrangement</td>
</tr>
<tr>
<td>d. The fair value of the outstanding loaned shares as of the balance sheet date</td>
</tr>
<tr>
<td>e. The treatment of the share-lending arrangement for the purposes of calculating earnings per share</td>
</tr>
<tr>
<td>f. The unamortized amount of the issuance costs associated with the share-lending arrangement at the balance sheet date</td>
</tr>
<tr>
<td>g. The classification of the issuance costs associated with the share-lending arrangement at the balance sheet date</td>
</tr>
<tr>
<td>h. The amount of interest cost recognized relating to the amortization of the issuance cost associated with the share-lending arrangement for the reporting period</td>
</tr>
<tr>
<td>i. Any amounts of dividends paid related to the loaned shares that will not be reimbursed.</td>
</tr>
</tbody>
</table>
ASC 470-20 (continued)

50-2B An entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing shall also make the disclosures required by Topic 505.

50-2C In the period in which an entity concludes that it is probable that the counterparty to its share-lending arrangement will default, the entity shall disclose the amount of expense reported in the statement of earnings related to the default. The entity shall disclose in any subsequent period any material changes in the amount of expense as a result of changes in the fair value of the entity's shares or the probable recoveries. If default is probable but has not yet occurred, the entity shall disclose the number of shares related to the share-lending arrangement that will be reflected in basic and diluted earnings per share when the counterparty defaults.

ASC 470-20 includes disclosure requirements related to own-share lending arrangements executed in contemplation of a convertible debt offering or other financing. These supplement the general requirements for the issuer’s disclosure of information about securities in ASC 505-10 (see Section 4.6 of this Roadmap and Chapter 7 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity).
Chapter 9 — Comparison of U.S. GAAP and IFRS Standards

9.1 Background

9.1.1 Circumstances in Which an Understanding of IFRS Standards May Be Relevant

An understanding of the differences between U.S. GAAP and IFRS Standards in an issuer’s accounting for convertible debt and other transactions within the scope of ASC 470-20 may be relevant for:

• U.S. entities that consolidate subsidiaries or other foreign operations that report under IFRS Standards.
• U.S. entities that provide financial statement information to a parent entity that reports under IFRS Standards.
• U.S. entities that negotiate transaction terms for contracts on own equity with entities that report under IFRS Standards (and vice versa).
• Entities that seek to compare their financial statements with those of international competitors.
• Foreign entities that report under IFRS Standards and consolidate subsidiaries or other operations that report under U.S. GAAP.
• Foreign entities that report under IFRS Standards and provide financial statement information to a parent entity that reports under U.S. GAAP.
• Investors and other users of financial statements that seek to compare financial statements prepared under U.S. GAAP and IFRS Standards.
• Standard setters and others that consider opportunities to converge accounting requirements.
• Parties that participate in discussions of new accounting requirements under U.S. GAAP or IFRS Standards or that seek to influence the development of new accounting requirements.

9.1.2 IFRS Guidance

Under IFRS Standards, an issuer applies IAS 32 to determine the classification of convertible securities. In making this determination, the issuer assesses whether an instrument must be separated into liability and equity components. IAS 32 has a broader scope than does ASC 470-20. For example, IAS 32 addresses the accounting for outstanding equity shares and freestanding contracts to purchase or sell the issuer’s equity shares (e.g., warrants, options, and forwards on the entity’s own equity). The discussion of key differences below applies only to contracts within the scope of ASC 470-20.
Connecting the Dots
For a discussion of key differences between U.S. GAAP and IFRS Standards related to contracts on an entity’s own equity that are within the scope of ASC 815-40, see Chapter 8 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*. For a discussion of key differences between U.S. GAAP and IFRS Standards related to the accounting for outstanding equity shares and other financial instruments that are within the scope of ASC 480-10 (including the SEC’s guidance on temporary equity in ASC 480-10-S99), see Chapter 10 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*.

9.2 Key Differences
The table below summarizes key differences between U.S. GAAP and IFRS Standards with respect to an issuer’s accounting for convertible debt and other transactions within the scope of ASC 470-20. The table is followed by a detailed explanation of each difference.

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
</table>
| General   | An issuer is required to present convertible debt as a liability in its entirety if (1) the equity conversion feature is not bifurcated as an embedded derivative under ASC 815-15, (2) the convertible debt is not within the Cash Conversion subsections of ASC 470-20, and (3) there is no separately recognized equity component that resulted from one of the following:  
  - The issuance of the convertible debt instrument at a substantial premium to par.  
  - The recognition of a BCF.  
  - A modification that increased the fair value of the conversion option.  
  - A reclassification of a conversion option that was previously classified as a derivative. | An issuer is required to separate convertible debt into liability and equity components, on the basis of the fair value of the liability component, unless the equity conversion feature must be bifurcated as an embedded derivative. |

| Convertible debt issued at a substantial premium | There is a rebuttable presumption that the premium associated with convertible debt issued at a substantial premium to par should be presented as equity unless the equity conversion feature is bifurcated as an embedded derivative or the CCF or BCF guidance applies. | There is no special accounting guidance on convertible debt issued at a substantial premium. An issuer is required to separate convertible debt into liability and equity components unless the equity conversion feature must be bifurcated as an embedded derivative. |

| Convertible debt with CCF | An issuer is required to separate convertible debt with a CCF into liability and equity components unless the equity conversion feature is bifurcated as an embedded derivative. The liability and equity components are separated by using a with-and-without approach on the basis of the fair value of similar nonconvertible debt. | An issuer is required to bifurcate the equity conversion feature in convertible debt with a CCF as an embedded derivative liability. |
Convertible debt with noncontingent BCF

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>An issuer is required to separate convertible debt with a noncontingent BCF into liability and equity components unless (1) the conversion feature must be bifurcated as an embedded derivative or (2) the CCF guidance applies. The equity component is measured at its initial intrinsic value.</td>
<td>There is no special accounting guidance for convertible debt with a noncontingent BCF. An issuer is required to separate convertible debt into liability and equity components unless the equity conversion feature must be bifurcated as an embedded derivative.</td>
</tr>
</tbody>
</table>

Convertible debt with contingent BCF

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>An issuer is required to recognize a contingent BCF in equity by reallocating an amount from the liability if or when the contingency is triggered unless (1) the conversion feature must be bifurcated as an embedded derivative, (2) the CCF guidance applies, or (3) the issuer has elected a fair value option for the instrument.</td>
<td>There is no special accounting guidance on convertible debt with a contingent BCF. An issuer is required to separate convertible debt into liability and equity components at inception unless the equity conversion feature must be bifurcated as an embedded derivative. An equity component is not remeasured when conversion price contingencies are triggered.</td>
</tr>
</tbody>
</table>

Conversions in accordance with original terms

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>No gain or loss is recognized on the conversion of traditional convertible debt in accordance with the original terms unless both (1) conversion occurred upon the issuer’s exercise of a call option and (2) the conversion option was not substantive at issuance. Issuers may be required to recognize a gain or loss or an expense upon the conversion of convertible debt subject to the CCF or BCF guidance or, if the conversion feature was not substantive at issuance, upon the issuer’s exercise of a call option. Upon conversion of a convertible debt instrument that has a separate equity component for a reason other than a CCF or BCF, the unamortized discount is recognized immediately as interest expense on that date.</td>
<td>No gain or loss is recognized upon the conversion of convertible debt at maturity in accordance with the original terms.</td>
</tr>
</tbody>
</table>

Extinguishments of convertible debt — allocation of the consideration paid upon redemption or repurchase

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional convertible debt — No allocation of the consideration paid. Convertible debt with a CCF — Consideration paid is allocated between the liability and equity components on the basis of the fair value of the liability component. Convertible debt with a BCF — Consideration paid is allocated between the liability and equity components on the basis of the current intrinsic value of the equity component.</td>
<td>Consideration paid is allocated between the liability and equity components on the basis of the fair value of the liability component.</td>
</tr>
</tbody>
</table>

Own-share lending arrangements executed in contemplation of convertible debt issuance or other financing

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special accounting guidance applies to equity-classified own-share lending arrangements executed in contemplation of convertible debt issuance or other financing.</td>
<td>There is no special accounting guidance for such arrangements.</td>
</tr>
</tbody>
</table>
9.3 Separation Into Liability and Equity Components

9.3.1 Traditional Convertible Debt

Under U.S. GAAP, the issuer of convertible debt is precluded from allocating to equity any of the proceeds received upon its issuance (see Chapter 4) if the convertible debt is not within the Cash Conversion subsections of ASC 470-20 and there is no separately recognized equity component that results from (1) the issuance of the convertible debt instrument at a substantial premium to par, (2) the recognition of a BCF, (3) a modification that increased the fair value of the conversion option, or (4) a reclassification of a conversion option that was previously classified as a derivative. If the equity conversion feature fails to satisfy the equity classification conditions in ASC 815-40, it is bifurcated as an embedded derivative only if it meets the bifurcation conditions in ASC 815-15 (including the net settlement characteristic in the definition of a derivative in ASC 815-10).

Under IFRS Standards, the issuer of a convertible debt instrument must separate it into liability and equity components if the feature meets the equity classification conditions in IAS 32. The issuer separates the instrument into its components by determining the fair value of the liability component and then deducting that amount from the fair value of the instrument as a whole; the residual amount is allocated to the equity component. If the equity conversion feature does not satisfy the equity classification conditions in IAS 32, it is bifurcated as an embedded derivative unless the issuer elects to apply the fair value option to the convertible debt.

Note that the definition of a derivative and the equity classification conditions under U.S. GAAP and IFRS Standards are not identical. Therefore, depending on the specific facts and circumstances, the assessment of whether an equity conversion option must be separated as an embedded derivative may differ under the two sets of standards (see Chapter 8 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity). Further, the circumstances in which an issuer may elect the fair value option are not the same, although the guidance in both sets precludes application of the fair value option to equity-classified items.

9.3.2 Convertible Debt Issued at a Substantial Premium

Under U.S. GAAP, there is a rebuttable presumption that the premium associated with convertible debt issued at a substantial premium to par should be presented in equity (see Chapter 5) unless the embedded conversion feature must be separated as an embedded derivative under ASC 815-15 or as an equity component under the CCF or BCF guidance in ASC 470-20.

As noted above, under IFRS Standards, the issuer of a convertible debt instrument must separate it into liability and equity components if the feature meets the equity classification conditions in IAS 32 (see Section 9.3.1 above). There is no special guidance on convertible debt issued at a substantial premium.

9.3.3 Cash Conversion Features

Under U.S. GAAP, a convertible debt instrument that contains a CCF must be separated into liability and equity components (see Chapter 6) unless the equity conversion feature has to be separated as an embedded derivative under ASC 815-15. The issuer separates the instrument into its components by determining the fair value of the liability component and then deducting that amount from the fair value of the instrument as a whole; the residual amount is allocated to the equity component.

Under IFRS Standards, an embedded conversion option that can be settled in cash upon conversion fails to meet the conditions for equity classification in IAS 32. Accordingly, an equity conversion feature that is separately presented as an equity component under the CCF guidance in ASC 470-20 would instead be accounted for as an embedded derivative liability under IFRS Standards unless the issuer elects to apply the fair value option to the convertible debt.
Paragraph B7 of FSP APB 14-1 states, in part:

Because the requirements for equity classification under U.S. GAAP (ASC 815-40) differ from the requirements for equity classification under IFRS (IAS 32), the [cash conversion] guidance in [ASC 470-20] does not converge with IFRS. In accordance with IAS 32, the conversion option embedded in a convertible debt instrument that may be settled in cash upon conversion (including partial cash settlement) would be bifurcated and accounted for at fair value as a derivative . . . unless the fair value option is elected for the instrument in its entirety. To accomplish convergence in the accounting for instruments within the scope of [the CCF guidance in ASC 470-20], a broad-based reconsideration of [ASC 815-40] would have been necessary, which the Board decided was beyond the scope of this project.

9.3.4 Beneficial Conversion Features

Under U.S. GAAP, a convertible debt instrument that contains a noncontingent BCF must be separated into liability and equity components (see Chapter 7) unless the equity conversion feature has to be separated as an embedded derivative under ASC 815-15 or as an equity component under the CCF guidance in ASC 470-20. The equity component is measured at the intrinsic value of the equity conversion feature. If a convertible debt instrument contains a contingent BCF, the issuer is required to recognize the intrinsic value of the conversion feature in equity if the contingency is triggered, with a corresponding reduction in the debt’s net carrying amount.

As noted above, under IFRS Standards, the issuer of a convertible debt instrument must separate it into liability and equity components if the feature meets the equity classification conditions in IAS 32 (see Section 9.3.1). There is no special guidance on convertible debt with a BCF. The equity component is not subsequently remeasured even if a contingent conversion feature is triggered or there is a contingent adjustment to the conversion price.

9.4 Derecognition

9.4.1 Conversions in Accordance With an Instrument’s Original Terms

Under U.S. GAAP, an issuer’s accounting for the conversion of a convertible debt instrument into equity shares in accordance with the instrument’s original terms depends on the particular circumstances:

- **Conversion of a traditional convertible debt instrument that was not separated into liability and equity components under ASC 470-20** — The net carrying amount of the debt is credited to equity to reflect the stock issued; no gain or loss is recognized (see Section 4.5.2) unless (1) the conversion occurred upon the issuer’s exercise of a call option and (2) the conversion option was not substantive at issuance. If the debt became convertible upon the issuer’s exercise of a call option and did not otherwise contain a substantive conversion feature as of its issuance date, debt extinguishment accounting applies (see Section 4.5.3).

- **Conversion of a convertible debt instrument that was separated into its liability and equity components in accordance with the CCF guidance in ASC 470-20** — A portion of the fair value of the consideration transferred upon conversion is allocated to the extinguishment of the liability component on the basis of the component’s conversion-date fair value (see Section 6.5). Any difference between this amount and the net carrying amount of the extinguished liability component is recognized currently in income.

- **Conversion of a convertible debt instrument that includes a separately presented BCF under ASC 470-20** — All of the unamortized discount remaining on the conversion date is recognized immediately as interest expense as of that date (see Section 7.6.1).

- **Conversion of a convertible debt instrument that includes a separate equity component for reasons other than a CCF or BCF** — All of the unamortized discount remaining on the conversion date is recognized immediately as interest expense as of that date (see Section 4.5.2.2).
Under IFRS Standards, as indicated in paragraph AG32 of IAS 32, upon the “conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.” (Under both U.S. GAAP and IFRS Standards, entities must recognize upon an induced conversion a loss that is equal to the difference between the fair value of the consideration transferred under the revised terms and the fair value of the consideration issuable under the original terms; see Section 4.5.4.)

9.4.2 Extinguishments

Under U.S. GAAP, if an issuer redeems or repurchases traditional convertible debt, it recognizes an extinguishment gain or loss that is equal to the difference between the reacquisition price and the net carrying amount of the extinguished debt (see Section 4.5.5). If the convertible debt is separated into liability and equity components under the CCF guidance in ASC 470-20, the reacquisition price of the extinguished debt is allocated between the liability and equity components on the basis of the extinguishment-date fair value of the liability component (see Section 6.5). If the convertible debt contains a separated BCF, a portion of the reacquisition price equal to the conversion feature’s extinguishment-date intrinsic value is allocated to equity and the remaining amount is allocated to the extinguishment of the debt (see Section 7.6.2). For instruments that are within the scope of the CCF or BCF guidance in ASC 470-20, any difference between the portion of the reacquisition price allocated to the liability component and its net carrying amount is recognized currently in income as an extinguishment gain or loss.

Under IFRS Standards, in accordance with paragraph AG33 of IAS 32, if an entity redeems or repurchases a convertible instrument before its maturity (without altering the conversion feature), the consideration paid (including any transaction costs) is allocated to the liability and equity components as of the date of the early redemption or repurchase on the basis of the extinguishment-date fair value of the liability component. The entity records a gain or loss in the income statement for any difference between the amount of the consideration allocated to the liability component and the liability component’s carrying amount at that time. The amount of consideration allocated to the equity component is recorded in equity, with no gain or loss recorded.

9.5 Own-Share Lending Arrangement in Connection With a Convertible Debt Issuance

Under U.S. GAAP, there is special guidance on the accounting for equity-classified own-share lending arrangements executed in contemplation of a convertible debt issuance (see Chapter 8). That guidance requires such arrangements to be initially measured at fair value and recognized as an issuance cost, with an offset to APIC. There is no equivalent accounting guidance under IFRS Standards.
Appendix A — Embedded Derivative Analysis

In determining the appropriate accounting for a convertible debt instrument, an issuer is required to evaluate whether the instrument contains any embedded features that must be accounted for as a derivative instrument separately from the host instrument. Examples of such features include equity conversion features, put and call options, indexed interest rate payments, inverse floating interest rate payments, leveraged interest rate payments, interest rate caps and floors, interest rate make-whole features, term-extension options, and foreign currency features.

Section 2.3 provides an overview of the accounting requirements that apply to the bifurcation of embedded derivatives in accordance with ASC 815-15. Because this Roadmap focuses on the issuer’s accounting for convertible debt under ASC 470-20, however, it does not comprehensively address the accounting requirements for derivative instruments. This appendix discusses some of the common questions an issuer may encounter in performing an embedded derivative analysis for a convertible instrument in accordance with ASC 815. In the discussion below, it is assumed that ASUs 2014-16 and 2016-06 have been adopted by the entity performing the analysis.

While an entity may be required to bifurcate embedded derivatives for recognition and measurement purposes, such features are usually combined with the host contract in an entity’s balance sheet. In the SEC’s Current Accounting and Disclosure Issues in the Division of Corporation Finance (as updated November 30, 2006), the SEC staff indicated that “embedded derivatives should be presented on a combined basis with the host contract, except in circumstances where the embedded derivative is a liability and the host contract is equity.”

A.1 Overview of Bifurcation Analysis for Embedded Features in Convertible Debt Instruments

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**25-1** An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- **a.** The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- **b.** The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
- **c.** A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of Subtopic 815-10 and this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)
The following six-step decision sequence illustrates how to apply this guidance in the evaluation of whether any embedded derivative features require bifurcation from a convertible debt instrument:

**Step 1**
Is the hybrid contract remeasured at fair value under other applicable U.S. GAAP, with changes in fair value recognized in earnings as they occur?

- Yes: The embedded feature(s) should not be bifurcated. Further analysis of the embedded feature under steps 2–6 is not required, and other applicable GAAP should be followed.
- No: Step 2

**Step 2**
Determine the nature of the host contract (i.e., whether the host contract is a debt or an equity host). This assessment is only performed as of the hybrid instrument’s initial recognition date (i.e., upon its issuance or acquisition).

**Step 3**
Identify each embedded feature.

**Step 4**
For each embedded feature, are the economic characteristics and risks clearly and closely related to those of the host contract (as determined in steps 2 and 3)?

- Yes: The embedded feature should not be bifurcated. Further analysis of the embedded feature under steps 5 and 6 is not required.
- No: Step 5

**Step 5**
On a freestanding basis, would the embedded feature meet the definition of a derivative in ASC 815-10-15-83?

- Yes: The embedded feature should not be bifurcated. Further analysis of the embedded feature under step 6 is not required.
- No: Step 6

**Step 6**
On a freestanding basis, would the embedded feature qualify for any scope exception in ASC 815-10-15?

- Yes: The embedded feature should not be bifurcated under ASC 815.
- No: The embedded feature must be bifurcated. If multiple embedded features must be bifurcated, see ASC 815-15-25-7 through 25-10.
A.1.1 Step 1 — Determine Whether the Hybrid Contract Is Remeasured at Fair Value Under Other Applicable GAAP, With Changes in Fair Value Recognized in Earnings as They Occur

If the hybrid contract is remeasured at fair value, with changes in fair value recognized in earnings, no embedded feature should be bifurcated (see ASC 815-15-25-1(b)) and further analysis under steps 2–6 is not required. If the hybrid contract is not remeasured at fair value, with changes in fair value recognized in earnings, step 2 should be applied.

Note that ASC 815 and ASC 825 prohibit election of the fair value option for a convertible debt instrument with an equity component that is required to be separately recognized upon original recognition (see Section 2.5). The guidance in ASC 825-10-15-5(f) specifically states that the fair value option may not be applied to “[f]inancial instruments that are, in whole or in part, classified by the issuer as a component of shareholders’ equity (including temporary equity) (for example, a convertible debt instrument within the scope of the Cash Conversion Subsections of Subtopic 470-20 or a convertible debt security with a noncontingent beneficial conversion feature).” Thus, an entity cannot elect the fair value option if a convertible debt instrument (1) is subject to the Cash Conversion subsections of ASC 470-20 (see Chapter 6), (2) contains a noncontingent BCF (see Chapter 7), or (3) was issued at a substantial premium to par (see Chapter 5).

A.1.2 Step 2 — Determine the Nature of the Host Contract

To determine the nature of the host contract, an entity first considers the form in which the hybrid instrument was issued. If the instrument was issued in the legal form of debt, the host contract is a debt instrument. If it was issued in the legal form of a share (see Section 6.2.2), the entity must consider the contract’s economic characteristics and risks to assess the nature of the host contract. To determine the economic characteristics and risks of such a host contract, an entity must consider all stated and implied substantive terms and features of the hybrid financial instrument. Neither its form (i.e., issued in the form of a share) nor its classification as a liability dictates that the host contract is a debt instrument, although the host contract almost always represents a debt instrument if it is classified as a liability.

If a liability-classified convertible instrument is issued in the form of a share, the reporting entity must apply the “whole-instrument” approach in determining the nature of the host contract. Under that approach, the entity determines the nature of the host contract by considering all the stated and implied substantive terms and features of the hybrid financial instrument, including the embedded feature that is being analyzed for bifurcation. Accordingly, the nature of the host contract is the same for each embedded feature. Further, ASC 815-15-25-17A indicates that when an entity evaluates “the stated and implied substantive terms and features [of the host contract], the existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. Although an individual term or feature may weigh more heavily in the evaluation on the basis of the facts and circumstances, an entity should use judgment based on an evaluation of all of the relevant terms and features.”

For additional information about determining the host contract in a convertible debt instrument issued in the form of a share, see Section A.2.

A.1.3 Step 3 — Identify Each Embedded Feature

A reporting entity identifies the terms of each embedded feature on the basis of the feature’s economic payoff profile rather than on the basis of how it has been formally documented. In identifying the embedded features, the entity should consider all of the convertible instrument’s terms.
Although the guidance in U.S. GAAP does not explicitly address how to determine the unit of accounting for embedded features in a hybrid instrument, the payoff profile approach is commonly applied. Under that approach, each embedded derivative feature in a hybrid instrument is identified on the basis of the monetary or economic value that the feature conveys to the instrument's counterparty upon settlement and not based solely on how the feature is described in the convertible instrument agreement. This approach is consistent with the definition of an embedded derivative in ASC 815-15-20, which focuses on how an implicit or explicit term affects the cash flows or values of other exchanges required by a contract. ASC 815-15-20 defines an embedded derivative as “[i]mplicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.”

Under the payoff profile approach, if a feature described in a convertible instrument agreement as a “redemption option” allows the holder to put the security to the issuer for cash equal to the greater of the face value of the security or the fair value of the underlying common stock, the instrument would be considered to contain the following two embedded derivative features: (1) a fixed-price redemption feature and (2) a cash-settled conversion feature. The redemption feature and the conversion feature must be analyzed separately under ASC 815-15-25-1.

A.1.4 Step 4 — Determine Whether the Economic Characteristics and Risks of Each Embedded Feature Are Clearly and Closely Related to Its Host Contract

Once the reporting entity has assessed the nature of the host contract, it should, in accordance with ASC 815-15-25-1(a), evaluate each embedded feature separately to determine whether its economic characteristics and risks are clearly and closely related to those of the host contract. If so, the embedded feature should not be bifurcated. If not, the reporting entity must perform further analysis to determine whether bifurcation of the embedded feature is required, as discussed in steps 5 and 6 below.

The next sections discuss how an entity assesses whether embedded redemption and conversion features are clearly and closely related to the debt host contract in convertible debt instruments that are hybrid instruments containing a debt host (which will nearly always be the case for convertible instruments classified as liabilities). They also discuss the unusual circumstance in which the host is an equity instrument.

A.1.4.1 Redemption Feature

To determine whether a redemption feature is clearly and closely related to the debt host contract, an entity would have to consider ASC 815-15-25-26 and ASC 815-15-25-40 through 25-43 (see further discussion in Sections A.5 and A.6). A redemption feature that is clearly and closely related to the host would not be bifurcated. If the feature is not clearly and closely related to the host, further analysis is required, as discussed in steps 5 and 6 below.

A redemption feature is not considered clearly and closely related to an equity host under ASC 815-15-25-20, which states, in part:

A put option that enables the holder to require the issuer of an equity instrument (which has been deemed to contain an equity host contract in accordance with paragraphs 815-15-25-17A through 25-17D) to reacquire that equity instrument for cash or other assets is not clearly and closely related to that equity instrument. . . . [T]he embedded written call option would not be considered to be clearly and closely related to the equity instrument.
A.1.4.2 Conversion Feature

ASC 815-15-25-51 states that “[t]he changes in fair value of an equity interest and the interest rates on a debt instrument are not clearly and closely related” and that, as a result, conversion options are not clearly and closely related to debt hosts. Therefore, the entity should consider the conversion feature not to be clearly and closely related to a debt host under ASC 815-15-25-1(a), and it should perform further analysis under steps 5 and 6 to determine whether the conversion feature requires bifurcation. See further discussion below and in Sections A.3 and A.4.

A conversion feature is generally considered clearly and closely related to an equity host under ASC 815-15-25-16, which states that “[i]f the host contract encompasses a residual interest in an entity, then its economic characteristics and risks shall be considered that of an equity instrument and an embedded derivative would need to possess principally equity characteristics (related to the same entity) to be considered clearly and closely related to the host contract.”

A.1.4.3 Interest Rate and Other Contingent Payment Features

The determination of whether interest rate-related or other contingent payment arrangements are clearly and closely related to a convertible debt instrument that contains a debt host contract should be based on the facts and circumstances. (See Sections A.6 and A.7 for discussion of contingent payments that are determined to be based on an interest rate-related underlying. See Section A.8 for discussion of whether contingent payments that are not determined to be based on an interest rate-related underlying represent credit-sensitive payments.) Contingent payment arrangements that (1) do not represent interest rate-related underlyings, (2) are not credit-sensitive payments, and (3) do not represent inflation-indexed interest payments under ASC 815-15-25-50 are generally not considered clearly and closely related to a debt host contract. For example, contingent payments that represent commodity-indexed or equity-indexed payments are not considered clearly and closely related to a debt host contract under ASC 815-15-25-48 and 25-49.

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<tr>
<td><strong>Commodity-Indexed Interest or Principal Payments</strong></td>
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<tr>
<td><strong>25-48</strong> The changes in fair value of a commodity (or other asset) and the interest yield on a debt instrument are not clearly and closely related. Thus, a commodity-related derivative instrument embedded in a commodity-indexed debt instrument shall be separated from the noncommodity host contract and accounted for as a derivative instrument.</td>
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| **Equity-Indexed Interest Payments** |
| **25-49** The changes in fair value of an equity interest and the interest yield on a debt instrument are not clearly and closely related. Thus, an equity-related derivative instrument embedded in an equity-indexed debt instrument (whether based on the price of a specific common stock or on an index that is based on a basket of equity instruments) shall be separated from the host contract and accounted for as a derivative instrument. |
A.1.4.4 Term Extension Features

The determination of whether a term-extension feature is clearly and closely related to a convertible debt instrument that contains a debt host requires evaluation under ASC 815-15-25-44 and 25-45:

**ASC 815-15**

25-44 An embedded derivative that either (a) unilaterally enables one party to extend significantly the remaining term to maturity or (b) automatically extends significantly the remaining term triggered by specific events or conditions is not clearly and closely related to the interest rate on a debt instrument unless the interest rate is concurrently reset to the approximate current market rate for the extended term and the debt instrument initially involved no significant discount. Thus, if there is no reset of interest rates, the embedded derivative is not clearly and closely related to the host contract. That is, a term-extending option cannot be used to circumvent the restriction in paragraph 815-15-25-26 regarding the investor’s not recovering substantially all of its initial recorded investment.

25-45 The preceding paragraph does not provide guidance for determining whether term-extending options in nondebt host contracts are clearly and closely related to the host contract, as discussed in paragraph 815-15-25-1(a). A term-extending option in a nondebt host contract can have a significantly different effect than a term-extending option in a debt host contract. Nondebt contracts (as well as debt contracts) that contain embedded term-extension features shall be evaluated under paragraph 815-15-25-1 to determine whether the term-extension feature is a derivative instrument that shall be accounted for separately.

Because the market interest rate for the extended term of a convertible debt instrument will be affected by the embedded conversion feature, an entity must use significant judgment in applying this guidance to a convertible debt instrument.

**A.1.5 Step 5 — Determine Whether the Embedded Feature, on a Freestanding Basis, Meets the Definition of a Derivative in ASC 815-10-15-83**

To be bifurcated, an embedded feature in a hybrid instrument must, on a freestanding basis, meet the definition of a derivative in ASC 815-10-15-83:

**ASC 815-10**

15-83 A derivative instrument is a financial instrument or other contract with all of the following characteristics:

a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
   1. One or more underlyings
   2. One or more notional amounts or payment provisions or both.

b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Net settlement. The contract can be settled net by any of the following means:
   1. Its terms implicitly or explicitly require or permit net settlement.
   2. It can readily be settled net by a means outside the contract.
   3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.
Often, the determination of whether the definition of a derivative is met focuses on the definition’s third component — the net settlement characteristic. Usually, an embedded feature in a hybrid financial instrument satisfies the other two components of the definition of a derivative (i.e., (1) underlyings and notional amounts or payment provisions and (2) no or little initial net investment). If the nature of the host contract is a debt host, which is almost always the case for a convertible instrument classified as a liability, an embedded redemption feature will satisfy the net settlement characteristic in the definition of a derivative (see ASC 815-10-15-107 through 15-109). If, however, the nature of the host contract is an equity host, whether the redemption feature satisfies the net settlement characteristic in the definition of a derivative generally depends on whether the hybrid contract is publicly traded and readily convertible to cash.

In addition, for a host contract whose nature is that of a debt host, a conversion feature will satisfy the net settlement characteristic if the issuer is a public company or the conversion option can be settled net in cash or net in shares. In determining whether the net settlement characteristic has been met, the reporting entity should also consider particular elements of the conversion feature, such as resale restrictions or the number of shares that will be received upon exercise and the impact of other embedded features. If the nature of the host contract is an equity instrument, this evaluation is typically unnecessary because the conversion feature is considered clearly and closely related to the host contract.

Interest rate-related or other contingent payment arrangements that are settled in cash will generally meet the definition of a derivative instrument. The same is usually true if the contingent payments are settled in a variable number of equity shares, even if they are not readily convertible to cash, because settlement of the derivative instrument involves delivery of an asset that is not associated with the underlying.

If the embedded feature meets all components of the definition of a derivative, step 6 should be applied. If not, no further analysis is required and the embedded feature should not be bifurcated.

A.1.6 Step 6 — Determine Whether the Embedded Feature Qualifies for any Scope Exception in ASC 815-10-15

If an embedded feature that is not clearly and closely related to the host contract meets the definition of a derivative on a freestanding basis, the entity should consider whether the feature meets any scope exceptions in ASC 815-10-15.

The issuer of a convertible debt instrument should evaluate whether the embedded conversion feature meets the scope exception in ASC 815-10-15-74(a) for contracts that are both (1) indexed to the issuer’s own stock and (2) classified in stockholders’ equity. This evaluation usually involves an analysis of the embedded feature under ASC 815-40. The investor cannot qualify for the scope exception in ASC 815-10-15-74(a). See further discussion in Sections A.3 and A.4.

A contingent interest rate or other payment arrangement may meet the exception in ASC 815-10-15-82 for registration payment arrangements.

A term-extension feature may meet the exception in ASC 815-10-15-69 through 15-71 for loan commitments.

If the embedded feature does not qualify for a scope exception, it should be bifurcated. If multiple embedded features must be bifurcated under ASC 815, they should not be accounted for as separate derivative instruments but rather as a single compound derivative instrument.
A.2 Determining the Host Contract in a Hybrid Instrument Issued in the Form of a Share

A convertible instrument issued in the legal form of debt is considered to contain a debt host contract.

In accordance with ASC 815-15-25-1(a) and ASC 815-15-25-17A, the determination of whether the host contract of a liability-classified convertible debt instrument issued in the form of a share is more akin to debt or equity depends on the nature of the hybrid instrument's economic characteristics and risks in accordance with ASC 815-15-25-17A through 25-17D.

ASC 815-15-25-17A includes the following guidance:

For a hybrid financial instrument issued in the form of a share, an entity shall determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature on the basis of the relevant facts and circumstances. That is, in determining the nature of the host contract, an entity shall consider the economic characteristics and risks of the entire hybrid financial instrument including the embedded derivative feature that is being evaluated for potential bifurcation. [Emphasis added]

Under this approach, commonly referred to as the “whole-instrument approach,” the nature of the host contract is the same for each embedded feature.

To determine the nature of the host contract under the whole-instrument approach, an entity performs the following steps (see ASC 815-15-25-17C):

1. Identify all of the hybrid financial instrument’s “stated and implied substantive terms and features” (emphasis added).
2. Determine whether the identified terms and features are more debt- or equity-like.
3. Identify the relative weight of the identified terms and features “on the basis of the relevant facts and circumstances.”
4. Reach a conclusion about the nature of the host contract.

An entity must identify the nature of the host contract as of the hybrid instrument’s initial recognition date (i.e., upon its issuance or acquisition). The entity would only be required to reassess that determination upon a modification or exchange of the hybrid instrument that is accounted for in a manner similar to an extinguishment. The determination of whether a reassessment is required for a modification or exchange that is not accounted for as an extinguishment will depend on the relevant facts and circumstances.

The sections below elaborate on these steps.

A.2.1 Identify the Hybrid Instrument’s Substantive Terms and Features

The first step in applying the whole-instrument approach is to identify all of the substantive terms and features of the hybrid financial instrument, whether stated or implied. Common terms and features in a convertible instrument issued in the form of a share include:

- Redemption rights.
- Conversion rights.
- Voting rights.
- Dividend rights.
- Protective covenants.
A.2.2 Determine Whether the Identified Terms and Features Are More Debt- or Equity-Like

The next step in applying the whole-instrument approach is to determine whether the identified substantive terms and features of the convertible instrument are more debt- or equity-like. To make this determination, a reporting entity should analyze the economic risks and characteristics of the term or feature.

The guidance in ASC 815-15-25-16 explains that a host contract would be considered equity-like if it “encompasses a residual interest in an entity.” By contrast, a term or feature that is not consistent with a residual interest in the issuing entity would most likely be considered debt-like. ASC 815-15-25-17D provides examples of common terms and features, discusses whether such terms and features are generally debt- or equity-like, and lists considerations that a reporting entity might use to determine the relative weight to assign to such terms and features.

The following chart illustrates which characteristics are generally more equity-like or debt-like:

For more information, see the other provisions of ASC 815-15-25-17D.
A.2.3 Weigh the Identified Terms and Features

The third step in applying the whole-instrument approach is to weigh each of the hybrid financial instrument’s substantive terms and features — qualitatively, quantitatively, or both — “on the basis of the relevant facts and circumstances,” as described in ASC 815-15-25-17C. The reporting entity determines the “relative strength” or weight of each of the hybrid financial instrument’s substantive terms and features by considering the following:

- The characteristics of the relevant terms and features themselves — For example, for a redemption option, the reporting entity should consider whether the option is (1) mandatory or optional and (2) contingent or noncontingent. A mandatory redemption right would be given more weight than an optional redemption right, and a noncontingent redemption right would be given more weight than a contingent redemption right. ASC 815-15-25-17D provides a list of characteristics that a reporting entity should consider in its analysis. Although not an all-inclusive list, these characteristics are discussed further in the table below.

- The circumstances under which the hybrid financial instrument was issued or acquired — This condition is generally meant to help an entity assess whether the hybrid financial instrument is in substance a residual interest in the issuing entity. For example, a hybrid financial instrument issued by a thinly capitalized entity (or one with an accumulated deficit) might be considered more equity-like than a hybrid financial instrument issued by a well-capitalized profitable entity. This is because in a thinly capitalized entity, the hybrid financial instrument may in substance represent a residual interest in that issuing entity even if other classes of equity are more subordinated.

- The potential outcomes of the hybrid financial instrument as well as the likelihood of those potential outcomes — This condition is meant to help an entity assess the hybrid financial instrument’s likely economic return. For example, a hybrid financial instrument that is expected to be settled in a fixed number of common shares (thus providing a more equity-like return) might be viewed as more equity-like than a hybrid financial instrument that is expected to be settled in a specified amount of cash or a variable number of shares that is equal to a fixed dollar amount (thus providing a more debt-like return).
The table below provides examples of indicators that a reporting entity should consider in determining whether to assign more or less weight to the general view related to whether a term or feature is debt-like or equity-like in the entity’s analysis of the nature of the host contract for a hybrid instrument issued in the form of a share. This table does not apply to hybrid instruments issued in the form of debt.

<table>
<thead>
<tr>
<th>General View</th>
<th>Indicators That the General View Should Be Given More Weight</th>
<th>Indicators That the General View Should Be Given Less Weight</th>
</tr>
</thead>
</table>
| Redemption rights are debt-like | • The redemption rights are held by an investor.  
• The instrument is mandatorily redeemable.  
• The redemption rights are noncontingent.  
• The term or feature is in-the-money (the degree to which the term or feature is in-the-money should also be considered).  
• For instruments with both redemption and conversion features, the redemption price or formula is more favorable than the conversion price or formula.  
• The issuer is well capitalized and profitable.  
• There are no laws restricting the exercise of the redemption rights.  
• The redemption rights can be exercised in circumstances besides liquidations.  
• The redemption feature can be settled by the issuer's transfer of a specified amount of cash or a variable number of shares that is equal to a fixed dollar amount. (A redemption amount that varies with the passage of time, such as how interest on a debt instrument accrues, would be a debt-like feature.) | • The redemption rights are held by the issuer.  
• The instrument is not mandatorily redeemable.  
• The redemption rights are contingent.  
• The term or feature is out-of-the-money (the degree to which the term or feature is out-of-the-money should also be considered).  
• For instruments with both redemption and conversion features, the redemption price or formula is less favorable than the conversion price or formula.  
• The issuer is thinly capitalized and incurring losses.  
• Laws might restrict the exercise of the redemption rights.  
• The redemption rights can only be exercised in the event of a liquidation.  
• The settlement value of the redemption feature is not fixed. (A redemption amount that varies with the passage of time, such as how interest on a debt instrument accrues, would be a debt-like feature.) |
| Conversion rights are an equity-like term or feature | • The conversion rights are held by an investor.  
• The instrument is mandatorily convertible.  
• The conversion rights are noncontingent.  
• The conversion term or feature is in-the-money (the degree to which the term or feature is in-the-money should also be considered).  
• For instruments with both redemption and conversion features, conversion is more likely to occur before redemption.  
• The instrument can be converted into or otherwise settled in a fixed number of common shares. | • The conversion rights are held by the issuer.  
• The instrument is not mandatorily convertible.  
• The conversion rights are contingent.  
• The conversion term or feature is out-of-the-money (the degree to which the term or feature is out-of-the-money should also be considered).  
• For instruments with both redemption and conversion features, conversion is less likely to occur before redemption.  
• The instrument is convertible into a variable number of shares equal to a fixed dollar amount. |
Appendix A — Embedded Derivative Analysis

(Table continued)

<table>
<thead>
<tr>
<th>General View</th>
<th>Indicators That the General View Should Be Given More Weight</th>
<th>Indicators That the General View Should Be Given Less Weight</th>
</tr>
</thead>
</table>
| Voting rights are an equity-like term or feature | • The voting rights allow holders of a class of stock to vote on all significant matters (i.e., exercise significant influence).  
• The voting rights allow the investor class to vote on the same matters as common stockholders.  
• The investor is granted the right to appoint board members. | • The voting rights are only protective (i.e., influence is not significant).  
• The voting rights of the investor class are more restrictive than those of the common stockholders.  
• The investor does not have the right to appoint board members. |
| Protective covenants are a debt-like term or feature | • For redemption options, redemption is guaranteed by the issuer’s parent.  
• The investor has certain rights that are akin to creditor rights (e.g., the right to force bankruptcy or a liquidation preference).  
• The investor has collateral requirements that are akin to those for collateralized debt. | • For redemption options, redemption is not guaranteed by any entity other than the issuer.  
• The investor has no rights that are akin to creditor rights.  
• There are no collateral requirements. |
| Dividends are either a debt-like or an equity-like feature | Dividend rights that are mandatory, stated, or cumulative add weight to the view that a debt host is more debt-like. Dividend rights that are discretionary, participating, or noncumulative add weight to the view that a debt host is more equity-like. | |

A.2.4 Reach a Conclusion About the Nature of the Host Contract

The final step of the whole-instrument approach is to reach a conclusion regarding the nature of the host contract on the basis of the results of the analyses performed in steps 1–3. As explained in ASC 815-15-25-17A, “[i]n evaluating the stated and implied substantive terms and features, the existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. Although an individual term or feature may weigh more heavily in the evaluation on the basis of the facts and circumstances, an entity should use judgment based on an evaluation of all of the relevant terms and features.” To further emphasize this point, the guidance in ASC 815-15-25-17A states by way of example that “an entity shall not presume that the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract, in and of itself, determines whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument.” If a reporting entity is still unclear about the nature of the host contract after performing this analysis, it should consider the expected outcome of the hybrid financial instrument in reaching its final conclusion.

Given the complexity of determining the nature of a host contract of a hybrid instrument with both conversion and redemption features, entities are encouraged to consult with their accounting advisers.

A.3 Bifurcation Analysis for Embedded Conversion Features

The guidance in this section applies to an issuer’s accounting for convertible debt instruments. It does not apply to nonconvertible debt (or mandatorily redeemable preferred stock) issued with detachable warrants or to share-settled redemption or indexation features (see Section 2.4).
To determine whether the embedded conversion option in a convertible debt instrument must be separated as an embedded derivative under ASC 815, the issuer should analyze the instrument under ASC 815-15-25-1.

A.3.1 Analysis Under the Guidance in ASC 815-15-25-1

A conversion option needs to be accounted for separately if all three conditions in ASC 815-15-25-1 are satisfied. Convertible debt issued in the form of debt consists of a debt host and an embedded conversion option; however, in unusual situations, convertible debt instruments issued in the form of a share may be considered to contain equity hosts. For an instrument issued in the form of a share, an analysis of the stated and implied substantive terms is always required (see Section A.2). Given the complexity of determining the nature of a host contract for a convertible instrument issued in the form of a share, entities are encouraged to consult with their accounting advisers. If entities conclude that the host is more akin to equity under ASC 815-15-25-16 and related guidance, the conversion option would be considered clearly and closely related to the host and would thus fail to meet the bifurcation criterion in ASC 815-15-25-1(a); no further analysis would be required.

The table below illustrates an analysis under ASC 815-15-25-1. In this analysis, the host instrument is considered a debt host and the issuer is not measuring the convertible debt instrument at fair value, with changes in fair value recorded in earnings. If the convertible debt instrument were being measured at fair value, with changes in fair value recorded in earnings (e.g., if the issuer elected to apply the fair value option to convertible debt that qualifies for the fair value option), the issuer would not bifurcate any embedded derivatives because the criterion in ASC 815-15-25-1(b) would not be met.

<table>
<thead>
<tr>
<th>Condition</th>
<th>Is the Condition Met?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASC 815-15-25-1(a)</strong> — “The economic characteristics and risks of the embedded derivative [instrument] are not clearly and closely related to the economic characteristics and risks of the host contract.”</td>
<td>Yes. An equity conversion option is not clearly and closely related to a debt host (see ASC 815-15-25-51).</td>
</tr>
<tr>
<td><strong>ASC 815-15-25-1(b)</strong> — The contract (“the hybrid instrument”) that embodies both the embedded derivative instrument and the host contract “is not remeasured at fair value under otherwise applicable [GAAP] with changes in fair value reported in earnings as they occur.”</td>
<td>Yes. The issuer does not elect to measure the convertible debt instrument at fair value through earnings. Note that ASC 825-10-15-5(f) precludes application of the fair value option to convertible debt instruments that contain a component that requires separate recognition within equity upon issuance.</td>
</tr>
<tr>
<td><strong>ASC 815-15-25-1(c)</strong> — “A separate instrument with the same terms as the embedded derivative would . . . be a derivative instrument subject to the requirements of [ASC 815]. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)”</td>
<td>Maybe. Whether the conversion option in a convertible debt or redeemable preferred stock instrument will meet the definition of a derivative that would be subject to the requirements of ASC 815 on a stand-alone basis primarily depends on whether the option may be net settled. If the option may be net settled (see table below for a definition) and does not qualify for the ASC 815-10-15-74(a) scope exception, this condition may be met. See further discussion below.</td>
</tr>
</tbody>
</table>

If any of the three above conditions is not met, no further analysis is necessary (i.e., the conversion option is not required to be separated as an embedded derivative). However, the conditions in ASC 815-15-25-1(a) and (b) will usually be met for convertible debt instruments, and an entity will need to perform further analysis to determine whether the condition in ASC 815-15-25-1(c) has been satisfied.
A.3.2 Is the Condition in ASC 815-15-25-1(c) Satisfied (i.e., if the Option Was Freestanding, Would It Meet the Definition of a Derivative)?

The following table presents an analysis of whether a typical conversion option meets the definition of a derivative in ASC 815-10-15-83:

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASC 815-10-15-83(a)(1)</strong> — “One or more underlyings.”</td>
<td>Yes. One underlying is the price of the shares that the instrument may be converted into.</td>
</tr>
<tr>
<td><strong>ASC 815-10-15-83(b)</strong> — It “requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.”</td>
<td>Yes. As noted in ASC 815-15-25-1(c), the initial investment in the hybrid instrument should not be considered the initial net investment for the embedded derivative. The initial investment in the embedded derivative typically would be considered approximately equal to the fair value of the conversion option. This amount would typically be smaller, by more than a nominal amount, than the amount that would be required to acquire the shares underlying the conversion option.</td>
</tr>
<tr>
<td><strong>ASC 815-10-15-83(c)</strong> — “Its terms implicitly or explicitly require or permit net settlement,” it “can readily be settled net by a means outside the contract,” or it “provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.”</td>
<td>Maybe. This characteristic would be met if either of the following occurs:</td>
</tr>
<tr>
<td></td>
<td>• The conversion option may be explicitly net settled at the option of either party. This would be the case if, under any scenario, the holder could receive cash or shares equal to the value of the conversion option without taking delivery of the full number of shares underlying the conversion option.</td>
</tr>
<tr>
<td></td>
<td>• The stock that the holder would receive upon conversion is publicly traded, and the number of shares that the holder would receive could be rapidly absorbed by the market without significantly affecting the price (see ASC 815-10-15-136).</td>
</tr>
</tbody>
</table>

In evaluating whether the conversion option can be explicitly net settled, the entity should consider all of the convertible debt instrument’s terms (e.g., redemption, liquidation features). Sometimes, the conversion option stipulates that, upon conversion, the issuer or the investor may choose to have the instrument settle in cash that is equal to the value of the shares that would be received upon conversion (in exchange for the convertible instrument) instead of having shares delivered. In such cases, the terms of the conversion option explicitly provide for net settlement of the conversion option.

In other cases, the instrument may be redeemable by the holder and, upon redemption, the holder receives cash equal to the greater of (1) the face value plus accrued interest or (2) the value of the shares that would be received had the holder exercised the conversion option (this alternative is sometimes described as cash equal to the fair value of the convertible instrument, which is presumably equal to the combined fair value of the debt host and the embedded conversion option). The conversion option, by its terms, may only be settled physically. In this case, however, the redemption feature permits the net cash settlement of the conversion option. See Section A.1 for additional guidance on evaluating convertible debt instruments with multiple embedded features.
If the conversion option meets the definition of a derivative on a stand-alone basis, it may still qualify for the scope exception in ASC 815-10-15-74(a) that applies to the issuer of the convertible debt instrument.

A.3.3 Applicability of the ASC 815-10-15-74(a) Scope Exception

ASC 815-10-15-74(a) provides a scope exception for contracts issued or held by a reporting entity that are both (1) indexed to the entity’s own stock and (2) classified in stockholders’ equity in the entity’s statement of financial position.

A.3.3.1 Indexed to the Entity’s Own Stock

ASC 815-40-15-5 through 15-8 provide guidance on whether an instrument or embedded feature is considered indexed to an entity's own stock (see Chapter 4 of Deloitte's A Roadmap to Accounting for Contracts on an Entity’s Own Equity for an in-depth discussion of this guidance). This guidance states that any instrument that is potentially settled in an entity's own stock and includes a contingency (i.e., a provision that entitles the entity (or the counterparty) to exercise the financial instrument on the basis of changes in an underlying, including the occurrence (or nonoccurrence) of a specified event), is potentially considered indexed to the entity's own stock (i.e., it is not precluded from classification as equity) as long as the exercise contingency is not based on (1) an observable market, other than the market for the issuer's stock (if applicable) or (2) an observable index, other than an index calculated or measured solely by reference to the issuer's own operations (e.g., the issuer's sales revenue).

In addition to performing the contingency test in ASC 815-40-15-7A and 15-7B, the entity also must assess whether the instrument's settlement features meet the criteria in ASC 815-40-15-7C through 15-7I for the instrument to be deemed indexed to the entity's own stock. An equity-linked instrument is considered indexed to the entity's own stock if either of the following two conditions is met:

- The instrument is a “fixed-for-fixed” forward or option on equity shares.
- The instrument is not fixed for fixed, but the only variables that could affect the instrument’s settlement amount are inputs used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares.

A.3.3.2 Classified in Stockholders’ Equity

If the entity can conclude that the instrument is indexed to the issuer’s stock, it must then apply the guidance in ASC 815-40-25 to determine whether the instrument would be classified in stockholders’ equity or as an asset or liability (see Chapter 5 of Deloitte's A Roadmap to Accounting for Contracts on an Entity’s Own Equity for an in-depth discussion of this guidance). ASC 815-40-25 provides guidance on financial instruments that are settleable in an entity’s own stock and includes a model that an entity should use to determine the appropriate balance sheet classification of the instruments. Generally, if the instrument can only be settled by physical delivery of shares, it would meet the criteria to be classified as equity under ASC 815-40 (thus qualifying for the ASC 815-10-15-74(a) scope exception). In addition, if the issuer has the right to choose between multiple settlement methods and one of those methods is physical settlement (i.e., delivery of the full amount of shares under the conversion option) or net share settlement, the instrument could meet the criteria to be classified as equity under ASC 815-40. Note that the issuer is required to perform an evaluation in accordance with ASC 815-40-25-7 through 25-35 and ASC 815-40-55-2 through 55-6 in determining whether the conversion feature would be classified as equity unless the instrument is considered a conventional convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the
Appendix A — Embedded Derivative Analysis

issuer's discretion). (See ASC 815-40-25-39 through 25-42 and Section 5.5 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity for guidance on determining whether a security is considered a conventional convertible security.) However, if the investor can require the issuer to settle the instrument in net cash (e.g., the investor can choose between net cash and physical settlement), the instrument would not meet the criteria to be classified as equity under ASC 815-40 and therefore would not qualify for the scope exception in ASC 815-10-15-74(a). See further discussion in Section A.4 below.

If the embedded conversion option is considered a derivative within the scope of ASC 815 and the other two bifurcation conditions described above are met, the issuer would be required to account for it separately. The host contract would be accounted for under otherwise-applicable U.S. GAAP. The embedded conversion option typically would not qualify as a hedging instrument for the issuer because entities are prohibited from hedging their own equity transactions (except in limited circumstances; see ASC 815-20-55-33 regarding an entity’s ability to designate a nonvested stock-appreciation-right obligation as a hedged item).

A.4 Conversion Option May Be Net Cash Settled Upon Contingent Event

If the investor in a convertible debt instrument (with a debt host contract) can net cash settle the embedded conversion option solely upon the passage of time, the option would not be classified in equity if it were a freestanding instrument. In such a case, if the option also met the bifurcation conditions in ASC 815-15-25-1(a) and (b), it would be a derivative that required bifurcation under ASC 815. However, if the investor's ability to net cash settle the conversion option is contingent on an event other than the passage of time and that event is outside the issuer's control, further analysis would be required, especially under ASC 815-40-25.

A.4.1 Overview

As noted in Section A.3, if the conditions in ASC 815-15-25-1(a) and (b) are satisfied, the issuer would be required to bifurcate a conversion option that may be net settled unless the conversion option is considered indexed to the entity's own stock and would qualify for equity classification on a stand-alone basis. ASC 815-40-25 provides general accounting guidance on the classification of derivatives indexed to a company's own stock (ASC 815-40-15-5 through 15-8 provide guidance on determining whether an equity-linked financial instrument (or embedded feature) is indexed to an entity's own stock). Generally, if the investor has the right to require the option to be settled in net cash, the conversion option would not meet the criteria to be classified in equity under ASC 815-40-25.

Sometimes, the investor’s right to require the issuer to settle the conversion option in cash is exercisable only upon the occurrence of a contingent event (the passage of time is not considered a contingent event). Generally, if a derivative indexed to an entity's own stock can be net cash settled at the option of the investor only upon the occurrence of the contingent event, and that contingent event is not within the issuer's control, the option would also not meet the criteria for equity classification under ASC 815-40-25.


As noted in ASC 815-40-25-39, some provisions of ASC 815-40-25 do not apply to certain embedded derivatives, such as nonseparable conversion options in "conventional" convertible debt (the same model should be applied to liability-classified convertible preferred stock that is similar to conventional convertible debt; however, convertible preferred stock without a mandatory redemption date would not qualify for the exception in ASC 815-40-25-39 (see ASC 815-40-25-42)).
For purposes of evaluating under paragraph 815-15-25-1 whether an embedded derivative indexed to an entity's own stock would be classified in stockholders' equity if freestanding, the requirements of paragraphs 815-40-25-7 through 25-35 and 815-40-55-2 through 55-6 do not apply if the hybrid contract is a conventional convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).

Instruments that provide the holder with an option to convert into a fixed number of shares (or equivalent amount of cash at the discretion of the issuer) for which the ability to exercise the option is based on the passage of time or a contingent event shall be considered conventional for purposes of applying this Subtopic. Standard antidilution provisions contained in an instrument do not preclude a conclusion that the instrument is convertible into a fixed number of shares.

If the terms of a conventional convertible debt instrument allow the investor to select net cash settlement only under certain contingent circumstances, the provisions of ASC 815-40-25 that would otherwise disqualify a conversion option from being classified as equity do not apply and the embedded derivative does not need to be accounted for separately under ASC 815-15-25-1. (See ASC 815-40-25-39 through 25-42 to determine whether the security is considered a conventional convertible instrument.)

The ability of a conversion option in conventional convertible debt to meet the criteria for equity classification is generally unaffected (and thus the option would be excluded from the scope of ASC 815-15-25-1 on the basis of the ASC 815-10-15-74(a) scope exception) if (1) the issuer has first concluded that the conversion option is indexed to its own stock and (2) net cash settlement can only occur under one or more of the following circumstances that may be outside the issuer's control (specifically, the provisions in ASC 815-40-25-7 through 25-35 and ASC 815-40-55-2 through 55-6):

- Settlement of the contract only by delivery of registered shares (if registered shares are unavailable, then settlement of the contract is net cash).
- The issuer's inability to make timely filings with the SEC.
- Cash-settled top-off or make-whole provisions.
- Change in control (generally).
- Bankruptcy.

However, an embedded conversion option in conventional convertible debt would not qualify for equity classification and would require bifurcation if it can be net cash settled (1) upon the occurrence of an event not discussed in ASC 815-40-25-7 through 25-35 or ASC 815-40-55-2 through 55-6 or (2) only upon the passage of time. Also, an embedded conversion option in a convertible debt instrument that is not considered a conventional convertible instrument would not qualify for equity classification and would require bifurcation if it could be net cash settled by the investor under any circumstances that are outside the issuer's control (including those events discussed in ASC 815-40-25-7 through 25-35 and ASC 815-40-55-2 through 55-6; in certain limited circumstances described in ASC 815-40-25-7 through 25-9, however, net cash settlement would not necessarily preclude equity classification).
The table below summarizes the interaction of these provisions:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Upon the mere passage of time</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Only under the conditions described in ASC 815-40-25-7 through 25-35 and ASC 815-40-55-2 through 55-6</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Under conditions other than those described in ASC 815-40-25-7 through 25-35 and ASC 815-40-55-2 through 55-6</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

A.5  Bifurcation Analysis for Put and Call Options in Debt Host Contracts

ASC 815-15-25-41 and 25-42 address whether call or put options that can accelerate the settlement of a debt instrument are clearly and closely related to the debt host contract. If an embedded feature represents a put or a call option that can accelerate the settlement of a convertible debt instrument (including a stock-settled redemption feature), an entity must apply ASC 815-15-25-41 and 25-42 to determine whether the option would be considered clearly and closely related to the debt host contract.

ASC 815-15

25-41 Call (put) options that do not accelerate the repayment of principal on a debt instrument but instead require a cash settlement that is equal to the price of the option at the date of exercise would not be considered to be clearly and closely related to the debt instrument in which it is embedded.

25-42 The following four-step decision sequence shall be followed in determining whether call (put) options that can accelerate the settlement of debt instruments shall be considered to be clearly and closely related to the debt host contract:

- **Step 1**: Is the amount paid upon settlement (also referred to as the payoff) adjusted based on changes in an index? If yes, continue to Step 2. If no, continue to Step 3.
- **Step 2**: Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, then that embedded feature is not clearly and closely related to the debt host contract and further analysis under Steps 3 and 4 is not required. If no, then that embedded feature shall be analyzed further under Steps 3 and 4.
- **Step 3**: Does the debt involve a substantial premium or discount? If yes, continue to Step 4. If no, further analysis of the contract under paragraph 815-15-25-26 is required, if applicable.
- **Step 4**: Does a contingently exercisable call (put) option accelerate the repayment of the contractual principal amount? If yes, the call (put) option is not clearly and closely related to the debt instrument. If not contingently exercisable, further analysis of the contract under paragraph 815-15-25-26 is required, if applicable.

¹ In certain limited circumstances described in ASC 815-40-25-7 through 25-9, net cash settlement would not necessarily preclude equity classification.
The following chart shows the four-step decision sequence under ASC 815-15-25-42 for determining whether an option would be considered clearly and closely related to the debt host contract.

In practice, a discount or premium in excess of 10 percent is considered “substantial” in the step 3 analysis. In determining whether a debt instrument was issued at a substantial premium or discount, an entity should use the amount allocated to the instrument for accounting purposes, not the total cash proceeds. In addition, the entity should consider the payoff of the embedded feature that is being analyzed. For example, if a debt instrument that was issued at par contains a put option that allows the investor to redeem the instrument at 112 percent of par value, the debt instrument would effectively be considered to involve a substantial discount.
The following table outlines and illustrates the application of the four steps in ASC 815-15-25-42:

<table>
<thead>
<tr>
<th>Steps</th>
<th>Examples of Terms That Would Result in a “Yes” Answer</th>
<th>Examples of Terms That Would Result in a “No” Answer</th>
</tr>
</thead>
</table>
| “Step 1: Is the amount paid upon settlement (also referred to as the payoff) adjusted based on changes in an index? If yes, continue to Step 2. If no, continue to Step 3.” | • The principal amount is adjusted for changes in the price of gold.  
• The principal amount is adjusted for changes in a stock market index.  
• The principal amount is adjusted to reflect changes in inflation rates (e.g., the consumer price index).  
• The principal amount is adjusted on the basis of the issuer’s earnings or EBITDA. | • The payoff is a fixed principal amount plus accrued interest.  
• The payoff is a fixed principal amount plus a premium that decreases ratably as the instrument approaches maturity. |
| “Step 2: Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, then that embedded feature is not clearly and closely related to the debt host contract and further analysis under Steps 3 and 4 is not required. If no, then that embedded feature shall be analyzed further under Steps 3 and 4.” | • Commodity-linked payoff (see ASC 815-15-25-48).  
• Equity-linked payoff (see ASC 815-15-25-49), such as debt that is callable by the issuer at par plus 5 percent of the change in the S&P 500.  
• Payoff linked to a credit risk exposure that is different from the borrower’s credit risk exposure (see ASC 815-15-25-47). | • Payoff directly linked to changes in the borrower’s credit rating (see ASC 815-15-25-46).  
• Nonleveraged inflation-indexed contracts in which the inflation rate is in the economic environment for the currency in which the debt is denominated (see ASC 815-15-25-50). |
| “Step 3: Does the debt involve a substantial premium or discount? If yes, continue to Step 4. If no, further analysis of the contract under paragraph 815-15-25-26 is required, if applicable.” | • Fixed-rate debt issued at a 12 percent discount to par and contingently puttable at par.  
• Fixed-rate debt issued at par that is contingently puttable for 110 percent of par. | • Debt puttable at par issued at a 6 percent discount to par.  
• Debt issued at a 3 percent discount to par that is callable upon an IPO at par plus the present value of unpaid future interest. |
| “Step 4: Does a contingently exercisable call (put) option accelerate the repayment of the contractual principal amount? If yes, the call (put) option is not clearly and closely related to the debt instrument. If not contingently exercisable, further analysis of the contract under paragraph 815-15-25-26 is required, if applicable.” | • Convertible debt with redemption feature that permits the investor to put the debt if an IPO occurs.  
• Debt with a redemption option that is exercisable by either the investor or the issuer upon a change in control.  
• Debt with a redemption option that is exercisable upon a change in interest of at least 150 basis points. | • The embedded option is exercisable at any time.  
• The embedded option is exercisable on the anniversary date of the issuance of the debt. |
As noted in steps 2, 3, and 4 of the decision sequence in ASC 815-15-25-42 for determining whether an embedded call or put is clearly and closely related to a debt host, an entity also must consider ASC 815-15-25-26, which generally does not apply to contingent call and put options embedded in a debt host contract. The guidance in ASC 815-15-25-26 applies only to embedded derivatives “in which the only underlying is an interest rate or interest rate index . . . that alters net interest payments that otherwise would be paid or received on an interest-bearing [debt] host contract.” An option that can be exercised only upon the occurrence or nonoccurrence of a specified event (e.g., an IPO or a change in control of the issuer) would always have a second underlying (e.g., the occurrence or nonoccurrence of the specified event). As a result of the existence of this second underlying, such contracts would therefore be excluded from the scope of ASC 815-15-25-26 unless the event was solely related to interest rates (e.g., a call that may only be exercised when LIBOR is at or above 5 percent) because the underlying would never be only an interest rate or interest rate index.

**Example A-1**

**Embedded Put Option Exercisable Upon a Change in Control**

Entity A issues a 10-year note at par, which becomes puttable to the issuer at 102 percent of par plus accrued interest if a change in control occurs at A.

As shown in the table below, A must apply the four-step decision sequence in ASC 815-15-25-42 to evaluate whether the embedded put option is clearly and closely related to the debt host:

<table>
<thead>
<tr>
<th>Example</th>
<th>Indexed Payoff? (Steps 1 and 2)</th>
<th>Substantial Discount or Premium? (Step 3)</th>
<th>Contingently Exercisable? (Step 4)</th>
<th>Embedded Option Clearly and Closely Related?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt issued at par is puttable at 102 percent of par, plus accrued interest, in the event of a change in control at A.</td>
<td>No. The amount paid upon settlement is not “adjusted based on changes in an index.” The payoff amount is fixed at 102 percent of par, plus accrued interest.</td>
<td>No. The debt is issued at par and puttable for a premium that is not substantial.</td>
<td>N/A. Analysis is not required because the answer to step 3 is no (i.e., no substantial discount or premium).</td>
<td>The embedded put option is clearly and closely related to the debt host. ASC 815-15-25-26 does not apply, because the change in control is considered a second underlying that is not an interest rate or an interest rate index.</td>
</tr>
</tbody>
</table>

In this example, a change in control is considered a second underlying of the embedded put option. Because the underlying of the embedded put option is not solely an interest rate or interest rate index, the guidance in ASC 815-15-25-26 does not apply to the analysis of whether the embedded put option is clearly and closely related to the debt host.

With respect to steps 1 and 2 of ASC 815-15-25-42, we believe that a payoff is considered “adjusted based on changes in an index” if the payoff is variable and changes in response to fluctuations in an index. In this case, there is only one possible payoff amount should the contingent event occur (a payoff at 102 percent plus accrued interest), even though the amount paid is not just the repayment of par plus accrued interest.

For a similar analysis, see Instrument 7 in the illustration in ASC 815-15-55-13.
A.6 Interest Rate Index Embedded in a Debt Host

Generally, interest rates are considered to be clearly and closely related to a debt host. The guidance in ASC 815-15-25-26 addresses how an entity would assess two conditions to determine whether an embedded derivative feature in a debt host in which the only underlying is an interest rate or interest rate index (i.e., an interest rate-related underlying) is not considered clearly and closely related to the debt host. ASC 815-15-25-26 states:

For purposes of applying the provisions of paragraph 815-15-25-1, an embedded derivative in which the only underlying is an interest rate or interest rate index (such as an interest rate cap or an interest rate collar) that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract that is considered a debt instrument is considered to be clearly and closely related to the host contract unless [one of two conditions exists.]

The first condition — ASC 815-15-25-26(a) — is as follows:

The hybrid instrument can contractually be settled in such a way that the investor (the holder or the creditor) would not recover substantially all of its initial recorded investment (that is, the embedded derivative contains a provision that permits any possibility whatsoever that the investor's [the holder's or the creditor's] undiscounted net cash inflows over the life of the instrument would not recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms).

The term “substantially all” in ASC 815-15-25-26 is generally interpreted to mean that at least 90 percent of the original investment (i.e., the undiscounted net cash flows received by the investor over the life of the debt instrument would equal at least 90 percent of the investment balance initially recorded by the investor).

Example A-2

**Bond With Leveraged Interest Rate Provision**

Company X invests in a $10 million 10-year bond that pays a fixed rate of 6 percent for the first two years and then pays a variable rate calculated as 14 percent minus the product of 2.5 times the three-month LIBOR, without a floor, for the remaining term of the bond. If the three-month LIBOR were to increase significantly, the bond might have a negative return, which would effectively erode its principal. In that case, X might not recover substantially all of its initial investment. The issuer should therefore separately account for the embedded interest rate derivative unless it has elected the option in ASC 815-15-25-4 or ASC 825-10-25-1 to measure the entire hybrid financial instrument at fair value, with changes in fair value recognized in earnings.

The second condition — ASC 815-15-25-26(b) — is as follows:

The embedded derivative meets both of the following conditions:

1. There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract (that is, the embedded derivative contains a provision that could under any possibility whatsoever at least double the investor's initial rate of return on the host contract).

2. For any of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed in (b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under the relevant future interest rate scenario) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception.

Note that ASC 815-15-25-37 states that the conditions in ASC 815-15-25-26(b)(1) and (b)(2) above do not apply to an embedded call option in a hybrid instrument that contains a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor (issuer/borrower).
Example A-3

**Bond Indexed to LIBOR on Leveraged Basis**

Company A invests in a 30-year variable-rate debt instrument issued by Company B. The instrument is indexed to the three-month LIBOR (3M LIBOR) plus 4 percent. As of the instrument's issuance date, the 3M LIBOR was 2 percent. The instrument's terms also specify that if the 3M LIBOR increases to 5 percent, the debt issuer is required to pay 23 percent for the remaining term of the bonds.

If B were to issue a 30-year variable-rate debt instrument without any embedded derivatives (i.e., the interest rate reset feature), it would pay a coupon of 3M LIBOR plus 6 percent. Consequently, the initial rate of return on the host contract is 8 percent (3M LIBOR of 2 percent plus 6 percent). Company A must determine whether the embedded derivative could at least double its initial rate of return on the host contract, which was 8 percent as of the issuance date, in any of the possible interest rate environments. When the 3M LIBOR increases to 5 percent, the 23 percent interest rate feature more than doubles the initial 8 percent rate of return on the host contract; therefore, the first condition (ASC 815-15-25-26(b)(1)) is satisfied.

To determine whether the second condition (ASC 815-15-25-26(b)(2)) is satisfied, A must assess whether, for any of the possible interest rate scenarios under which its initial rate of return on the host contract would be doubled (i.e., when the 3M LIBOR is at 5 percent), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return on a contract with the same terms as the host contract. When the 3M LIBOR increases to 5 percent, the rate of return on a contract that has the same terms as the host contract (and involves a debtor with a credit quality similar to that of B at debt inception) would be 11 percent (3M LIBOR of 5 percent plus 6 percent). The second condition is therefore also satisfied because when the 3M LIBOR increases to 5 percent, the 23 percent return generated by the embedded derivative feature in the debt is more than twice the 11 percent return (3M LIBOR of 5 percent plus 6 percent) on the contract with the same terms as the host contract.

Companies A and B would each be required to account for the embedded derivative separately unless either has elected the option in ASC 815-15-25-4 or ASC 825-10-25-1 to measure the entire hybrid financial instrument at fair value, with changes in fair value recognized in earnings.

While the conditions in ASC 815-15-25-26(a) and (b) above focus on the investor's rate of return and recovery of its investment, if either of those conditions is satisfied, neither party to the hybrid instrument would consider the embedded derivative feature to be clearly and closely related to the host contract. Furthermore, ASC 815-15-25-26 indicates that when an entity assesses whether it meets one of the conditions, it should not consider whether it is probable that the condition will be satisfied; the condition should be considered satisfied if there is any possibility whatsoever that it will be met. Therefore, in Example A-3 above, the probability that the 3M LIBOR will increase to 5 percent is not relevant to the analysis of whether the condition is met. However, an entity should consider such probability when valuing the embedded derivative.

See Section A.7 below for further discussion of the application of the “double-double” test in ASC 815-15-25-26(b).

### A.7 Application of the Double-Double Test in ASC 815

When evaluating whether an embedded derivative in which the only underlying is an interest rate or interest rate index (i.e., an interest rate-related underlying) is clearly and closely related to its interest-bearing host, an entity must apply the test established by ASC 815-15-25-26(b) (i.e., the double-double test). The double-double test consists of two tests that are performed on the date on which the instrument is acquired (or incurred) by the reporting entity.

In the first of the two tests, the entity that performs the evaluation must determine whether there is a possible future interest rate scenario, no matter how remote, in which the embedded derivative would at least double the investor's initial rate of return on the host contract. In making this assessment, the
entity must differentiate the return on the host contract from the return on the hybrid contract. The host contract excludes the effects of the embedded derivative. If an embedded derivative does not pass this test, it would be considered clearly and closely related to its host (provided that it does not meet the condition in ASC 815-15-25-26(a)). If the embedded derivative does pass this test, the entity must perform a second test to determine whether it is clearly and closely related to the host contract.

In the second test, the entity must determine whether, for any of the scenarios identified in the first test for which the investor’s initial rate of return on the host contract would be doubled, the embedded derivative would at the same time result in a rate of return that (1) is at least twice what otherwise would be the then-current market return (under the relevant future interest rate scenario) for a contract that has the same terms as the host contract and (2) involves a debtor with a credit quality similar to that of the issuer’s at inception. If the embedded derivative also passes this test, it would not be considered clearly and closely related to its host contract.

If the second test is not passed (and the embedded derivative does not meet the condition in ASC 815-15-25-26(a)), the embedded derivative would be considered clearly and closely related to the host contract.

### Example A-4

**Bond With Interest Rate Cap Provision**

On January 1, 20X1, Company A purchases a bond at par that pays LIBOR. The bond also incorporates an interest rate cap provision stating that A will receive a return of 10 percent if LIBOR equals or exceeds 8 percent as of any interest rate reset date. On the date A purchases the bond, it also could purchase at par a variable-rate bond that does not contain a cap and that pays LIBOR minus 1 percent from a debtor with the same credit quality as the issuer of A’s bond. As of January 1, 20X1, LIBOR is 5 percent. The bond cannot contractually be settled in a manner in which A would not recover substantially all of its initial recorded investment in the bond. To perform the first test in ASC 815-15-25-26(b), A must determine whether there is any interest rate scenario, no matter how remote, under which the embedded derivative (the cap) would at least double its initial rate of return on the host contract. This analysis is summarized in the following table:

<table>
<thead>
<tr>
<th>A LIBOR Interest Rate Range</th>
<th>B Return Reflecting the Effect of Cap</th>
<th>C Initial Rate of Return on Host (LIBOR — 1%)</th>
<th>D Initial Rate of Return on Host Doubled</th>
<th>Is the ASC 815-15-25-26(b)(1) Test Met — Is B &gt; D?</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–7.99%</td>
<td>0–7.99%</td>
<td>4%</td>
<td>8%</td>
<td>No</td>
</tr>
<tr>
<td>8% and up</td>
<td>10%</td>
<td>4%</td>
<td>8%</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Example A-4 (continued)

Because the first test has been satisfied, A must perform the second test in ASC 815-15-25-26(b) to determine whether the embedded cap is clearly and closely related to its bond host. In this test, A must determine, for any of the possible interest rate scenarios identified above under which A’s initial rate of return on the host contract would be doubled, whether the embedded cap would simultaneously result in a rate of return that is at least twice what otherwise would be the then-current market return (under the relevant future interest rate scenario) for a contract that has the same terms as the host contract and involves a debtor with a credit quality similar to that of the issuer’s at inception. Company A’s analysis for this test can be summarized as follows:

<table>
<thead>
<tr>
<th>A</th>
<th>Interest Rate Scenario Identified in the ASC 815-15-25-26(b)(1) Test for Which the Cap Would at Least Double the Investor’s Initial Rate of Return on the Host Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Return Reflecting the Effect of the Cap Under the Interest Rate Scenario in A</td>
</tr>
<tr>
<td>C</td>
<td>Current Market Rate of Return for a Contract Having the Same Terms as the Host Contract Under the Interest Rate Scenario in A (LIBOR — 1%)</td>
</tr>
</tbody>
</table>

| 8% and up | 10% | 7% and up | No |

Since both of the ASC 815-15-25-26(b) tests are not met, the embedded cap is considered clearly and closely related to the bond host.

A.8 Credit-Sensitive Payments

ASC 815-15

25-46 The creditworthiness of the debtor and the interest rate on a debt instrument shall be considered to be clearly and closely related. Thus, for debt instruments that have the interest rate reset in the event of any of the following conditions, the related embedded derivative shall not be separated from the host contract:

a. Default (such as violation of a credit-risk-related covenant)

b. A change in the debtor’s published credit rating

c. A change in the debtor’s creditworthiness indicated by a change in its spread over U.S. Treasury bonds.

25-47 If an instrument incorporates a credit risk exposure that is different from the risk exposure arising from the creditworthiness of the obligor under that instrument, such that the value of the instrument is affected by an event of default or a change in creditworthiness of a third party (that is, an entity that is not the obligor), then the economic characteristics and risks of the embedded credit derivative are not clearly and closely related to the economic characteristics and risks of the host contract, even though the obligor may own securities issued by that third party. This guidance shall be applied to all other arrangements that incorporate credit risk exposures that are unrelated or only partially related to the creditworthiness of the issuer of that instrument. This guidance does not affect the accounting for a nonrecourse debt arrangement (that is, a debt arrangement in which, in the event that the debtor does not make the payments due under the loan, the creditor has recourse solely to the specified property pledged as collateral).

With the exception of certain inflation-indexed payment features addressed in ASC 815-15-25-50, if a contingent payment feature embedded in a debt host contract is not an interest rate-related underlying and is not considered a credit-sensitive payment, it is not clearly and closely related to the debt host contract and must be bifurcated as an embedded derivative under ASC 815-15-25-1(a) if the conditions in ASC 815-15-25-1(b) and (c) are met.
Convertible debt instruments often contain provisions that require the issuer to pay additional interest upon the occurrence of an “event of default.” Depending on the situations that result in an event of default, as defined in the convertible debt agreement, such a contingent payment may not be considered a credit-sensitive payment and therefore may not be considered clearly and closely related to the debt host. The table below discusses common situations that may be described as events of default and whether such triggering events constitute a credit-sensitive payment.

<table>
<thead>
<tr>
<th>Triggering Event</th>
<th>Credit-Sensitive Payment?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any representation or warranty made by the issuer that is not correct</td>
<td>Yes</td>
</tr>
<tr>
<td>Failure to perform or comply with financial or nonfinancial covenants</td>
<td>Yes, unless the covenants include items that do not affect the issuer’s credit risk</td>
</tr>
<tr>
<td>Bankruptcy or insolvency</td>
<td>Yes</td>
</tr>
<tr>
<td>Cross default on other indebtedness</td>
<td>Yes, unless the default on the other indebtedness arises from events that are not credit-related</td>
</tr>
<tr>
<td>Invalidity of or failure to maintain loan or collateral documents</td>
<td>Yes</td>
</tr>
<tr>
<td>Nonpayment of principal or interest when due</td>
<td>Yes</td>
</tr>
<tr>
<td>Judgments or orders against the issuer exceeding a specific amount</td>
<td>Yes</td>
</tr>
<tr>
<td>Revocation of a license or permit to perform business operations that results in a material adverse effect</td>
<td>Yes</td>
</tr>
<tr>
<td>Criminal events of the issuer</td>
<td>Yes</td>
</tr>
<tr>
<td>A change in control of the issuer</td>
<td>No</td>
</tr>
<tr>
<td>Key person event</td>
<td>Depends on facts and circumstances</td>
</tr>
</tbody>
</table>
Appendix B — Accounting for Conversion of Convertible Debt Instrument With a Bifurcated Embedded Conversion Option

This appendix describes potential alternative views on an issuer’s accounting for the simultaneous physical share settlement of a debt host contract and a bifurcated embedded conversion option before the contractual maturity of the debt instrument.

Example B-1

**Accounting Views WhenConvertible Debt With a Bifurcated Conversion Option Is Converted in Accordance With Its Stated Conversion Terms**

On January 1, 20X7, Company A issued a convertible debt instrument with a stated interest rate of 5 percent and a principal amount of $1,000. At the option of the holder, the debt could be converted into 100 shares of A’s common stock at any time. If the debt is not converted before January 1, 20X9, A would be required to repay the principal amount of the debt in cash. The fair value of A’s common stock on January 1, 20X7, was $10 per share.

Company A separately accounted for the embedded conversion option as a derivative liability under ASC 815-15 because of assumed net-cash settlement requirements upon the occurrence of certain events outside of A’s control. However, the stated terms of the convertible debt instrument require physical share settlement upon conversion. The following additional facts are related to the convertible debt instrument:

- On January 1, 20X7, the fair value of the embedded conversion option was $200.
- On June 1, 20X8, the fair value of the embedded conversion option was $400 ($300 of intrinsic value plus $100 in time value). The carrying amount of the host contract was $950. There was no accrued or unpaid interest.
- On June 1, 20X8, the holder converted the instrument in accordance with its original conversion terms and received 100 shares of A’s common stock, which had a fair value of $1,300 ($13 per share × 100 shares).

In addition, assume the following:

- The embedded conversion option was bifurcated from the host debt contract on the issuance date of the convertible debt instrument. As a result, the instrument was not subject to the Cash Conversion subsections of ASC 470-20 or the BCF guidance in ASC 470-20 on the issuance date.
- It was deemed reasonably possible that the embedded conversion option could be exercised on the instrument’s issuance date.
- According to the terms of the convertible debt instrument, (1) the issuer does not have the option to partially settle a conversion in cash (e.g., the issuer cannot settle the principal amount in cash and the excess conversion value in common shares) and (2) accrued and unpaid interest is not forfeited upon conversion.

Alternative views on the accounting for such a conversion are discussed below.
Appendix B — Accounting for Conversion of Convertible Debt Instrument With a Bifurcated Embedded Conversion Option

Example B-1 (continued)

**View 1 — Extinguishment Accounting**

Under View 1, equity should be increased by the settlement-date fair value of the common shares issued and a gain or loss should be recognized in earnings for the difference between (1) the fair value of those shares and (2) the sum of the carrying amounts of the debt host and the bifurcated conversion option liability.

Accordingly, A would record the following journal entry upon conversion:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt host liability</td>
<td>950</td>
</tr>
<tr>
<td>Conversion option liability</td>
<td>400</td>
</tr>
<tr>
<td>Common stock/APIC</td>
<td>1,300</td>
</tr>
<tr>
<td>Gain upon extinguishment</td>
<td>50*</td>
</tr>
</tbody>
</table>

* The gain upon extinguishment represents the excess of the remaining time value in the conversion option over the remaining unamortized discount on the debt host ($100 – $50 = $50).

Proponents of View 1 believe that once the embedded conversion option has been separated from the debt host contract under ASC 815-15, the debt instrument no longer has an equity conversion feature (i.e., the financial instruments are considered separate for accounting purposes). ASC 470-50-40-3 indicates that both of the separated liabilities are subject to extinguishment accounting and that the guidance on early extinguishments of debt in ASC 470-50-40-2 (which requires a gain or loss to be recognized on the basis of the difference between the reacquisition price and the net carrying amount of the extinguished debt) applies to extinguishments that are affected by the issuance of common stock. Under ASC 470-50-40-3, the reacquisition price of extinguished debt is determined on the basis of the value of either the common stock issued or the debt — whichever is more clearly determinable.

To support their position, proponents of View 1 observe that the pre-Codification guidance in paragraph 16 of APB Opinion 26 states that "the essential economics of the decision leading to the early extinguishment of outstanding debt are the same, regardless of whether such debt is extinguished via the use of the existing liquid assets, new equity securities, or new debt." That reasoning was part of the FASB's rationale for issuing guidance (which was ultimately codified in ASC 470-50-40-3) that requires the difference between the fair value of the shares and the carrying amount of the liability to be considered a gain or loss related to extinguishment of the existing debt.

Proponents of View 1 further support their position on the basis of an analogy to the pre-Codification guidance in EITF Issue 03-7 that required a gain or loss to be recorded for the liability portion of a conversion of a convertible debt instrument in the form of Instrument C. Although EITF Issue 03-7 was not codified because it was superseded by FSP APB 14-1, proponents of View 1 believe that the guidance in that Issue is relevant since (1) it was applied before the approach in FSP APB 14-1 (now the Cash Conversion subsections of ASC 470-20) was required and (2) FSP APB 14-1 does not address the accounting for a conversion of convertible debt with a bifurcated embedded conversion option.

Opponents of View 1 believe that it is not appropriate to record a gain for the forgone time value in the embedded conversion option. Some maintain that proponents' analogy to EITF Issue 03-7 is improper because the distinguishing factor in EITF Issue 03-7 was the partial cash settlement of a conversion. Other opponents believe that under ASC 815-40, the embedded conversion option would be reclassified to equity at its then carrying amount immediately before accounting for the conversion.

Some opponents of View 1 also believe that recording a loss for the unamortized portion of the discount on the debt host is inconsistent with the guidance in ASC 470-20-40-4, which requires any unamortized discount or premium to be credited to the capital accounts when a convertible debt instrument is converted into common stock in accordance with its original conversion terms. These opponents believe that ASC 470-20-40-4 applies even though the embedded conversion option was classified as a derivative liability on the conversion date.

In addition, some opponents of View 1 believe that the analogy to the guidance in paragraph 16 of Opinion 26 is inappropriate because Opinion 26 did not ultimately require extinguishment accounting for convertible debt that is converted in accordance with its original terms. However, they acknowledge that at the time that guidance was written, GAAP did not require separation of the embedded conversion option as a derivative liability under any circumstances.
Example B-1 (continued)

**View 2 — Conversion Accounting**

Under View 2, equity should be increased by the sum of the carrying amounts of the debt host and bifurcated conversion option liability, with no gain or loss recognized in earnings.

Accordingly, A would recognize the following journal entry upon conversion:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt host liability</td>
<td>950</td>
</tr>
<tr>
<td>Conversion option liability</td>
<td>400</td>
</tr>
<tr>
<td>Common stock/APIC</td>
<td>1,350</td>
</tr>
</tbody>
</table>

Proponents of View 2 believe that ASC 470-20-40-4, which requires conversion accounting (i.e., no gain or loss is recorded), applies to the conversion of the debt instrument in accordance with its original terms. Thus, ASC 470-20-40-4 would apply in this scenario since the settlement of the debt host and bifurcated conversion option liability did not involve a transfer of cash. Proponents also note that under ASC 470-50-40-5, conversion accounting applies if a debt instrument is tendered to exercise detachable warrants that were originally issued with the debt, provided that the debt is permitted to be tendered toward the warrants’ exercise price under the terms of the securities at issuance. That guidance, which does not specify that it applies only to warrants classified in equity, supports the conclusion that regardless of whether the debt host and the embedded conversion option are considered to be separate for accounting purposes, extinguishment accounting does not apply (i.e., conversion accounting applies) if the settlement of those instruments occurs through the issuance of shares in accordance with the conversion privileges provided in the terms of the debt at issuance. Consequently, proponents of View 2 believe that it is the form of the instrument and the conversion terms, rather than the accounting classification, that determine the appropriate accounting for the conversion.

Some proponents of View 2 also believe that it represents the appropriate accounting under ASC 815-40 because the embedded conversion option should be reclassified to equity immediately before the settlement is accounted for.

However, opponents of View 2 point out that the guidance in ASC 470-20-40-4 and ASC 470-50-40-5 was written when GAAP did not require the conversion option to be separated from the debt host contract, and therefore they believe that the settlement should be accounted for under other GAAP (see Views 1 and 3).

**View 3 — Conversion Accounting With Immediate Expense of Unamortized Discount**

Under View 3, the remaining unamortized discount on the debt host should be immediately recognized in earnings, and then equity should be increased by the sum of the carrying amounts of the debt host and the bifurcated conversion option liability, with no additional gain or loss recognized in earnings.

Accordingly, A would recognize the following journal entries upon conversion:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>50</td>
</tr>
<tr>
<td>Debt host liability</td>
<td>50</td>
</tr>
<tr>
<td>Debt host liability</td>
<td>1,000</td>
</tr>
<tr>
<td>Conversion option liability</td>
<td>400</td>
</tr>
<tr>
<td>Common stock/APIC</td>
<td>1,400</td>
</tr>
</tbody>
</table>

Some proponents of View 3 point to the guidance in ASC 815-15-40-1 on the accounting for a conversion of a debt instrument with a previously bifurcated embedded conversion option in accordance with its original conversion terms. Under that guidance, any unamortized discount on the debt host is immediately recorded to income, and then the carrying amount of the liability is reclassified to equity. Because the issuer meets the conditions for classification of the embedded conversion option immediately before settlement of the conversion, some proponents of View 3 believe that ASC 815-15-40-1 applies to the settlement of the debt host and bifurcated conversion option liability. Therefore, the issuer reclassifies the bifurcated conversion option liability to equity immediately before accounting for the conversion as specified by ASC 815-15-40-1.
Example B-1 (continued)

Other proponents of View 3 believe that the situation in this example differs from that discussed in ASC 815-15-40-1 but that the application of ASC 815-15-40-1 (analogously) and ASC 815-40-40-2 would achieve the same result. Those proponents believe that ASC 815-15-40-1, by analogy, applies to the settlement of the debt host, and ASC 815-40-40-2 applies to the settlement of the bifurcated conversion option liability. ASC 815-40-40-2 states that “[i]f contracts classified as assets or liabilities are ultimately settled in shares, any gains or losses on those contracts shall continue to be included in earnings.” That is, prior gains and losses are not reclassified from earnings, and no additional gain or loss is recorded upon settlement (i.e., any remaining time value in the derivative is recorded to equity).

Proponents of View 3 believe that their view is consistent with the guidance in EITF Issue 03-7, which required the equity-derivative portion of the instrument to be recorded directly to equity, with no additional gain or loss recorded. They believe that this guidance can be applied analogously because EITF Issue 03-7 effectively treats the principal amount and conversion feature separately for settlement purposes, even though the two features had not been previously separated for accounting purposes. In other words, proponents of View 3 believe that the guidance in GAAP prohibits an entity from recording the forgone time value to earnings.

Opponents of View 3 believe that ASC 815-15-40-1 does not apply to this type of conversion and that the guidance in GAAP therefore does not require the immediate amortization of the unamortized discount on the debt host.

On the basis of our understanding of discussions among members of the SEC OCA, we believe that the SEC staff would not object to any of the three alternative views discussed in the above example because (1) the guidance in GAAP does not specifically address the issue and (2) each alternative view emanates from a reasonable interpretation of analogous guidance. We believe that an entity should disclose which view it applied and how that view affected its statement of financial performance and results of operations.

Note that the discussion in the above example does not apply to a convertible debt instrument with a bifurcated embedded conversion option that is converted into common shares in accordance with its original conversion terms on the instrument’s maturity date. On that date, there is no remaining unamortized discount on the debt host, and the sum of the debt host and embedded conversion option would be expected to equal the intrinsic value, if any, of the conversion right in the instrument.
## Appendix C — Original Pronouncements Codified in ASC 470-20

<table>
<thead>
<tr>
<th>Issue</th>
<th>Original Pronouncement</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting for convertible debt and debt issued with stock purchase warrants</td>
<td>APB Opinion 14</td>
<td>Chapters 4 and 5 and Sections 3.4 and 3.5</td>
</tr>
<tr>
<td>Accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) or other assets upon conversion</td>
<td>FSP APB 14-1</td>
<td>Chapter 6</td>
</tr>
<tr>
<td>Debt tendered to exercise warrants</td>
<td>AIN-APB 26</td>
<td>Section 4.5.2</td>
</tr>
<tr>
<td>Induced conversions of convertible debt</td>
<td>FASB Statement 84</td>
<td>Section 4.5.4</td>
</tr>
<tr>
<td>Debt exchangeable for the stock of another entity</td>
<td>EITF Issue 85-9</td>
<td>Section 2.7</td>
</tr>
<tr>
<td>Accrued interest upon conversion of convertible debt</td>
<td>EITF Issue 85-17</td>
<td>Section 4.5.2.1</td>
</tr>
<tr>
<td>Accounting for convertible securities with BCFs or contingently adjustable conversion ratios</td>
<td>EITF Issue 98-5, EITF Issue 00-27, and EITF Issue 08-4</td>
<td>Chapter 7</td>
</tr>
<tr>
<td>Accounting for a convertible instrument granted or issued to a nonemployee for goods or services or a combination of goods or services and cash</td>
<td>EITF Issue 01-1</td>
<td>Sections 2.8 and 7.3.5</td>
</tr>
<tr>
<td>Determining whether certain conversions of convertible debt to equity securities should be accounted for as induced conversions</td>
<td>EITF Issue 02-15</td>
<td>Section 4.5.4</td>
</tr>
<tr>
<td>Accounting for the conversion of an instrument that became convertible upon the issuer’s exercise of a call option</td>
<td>EITF Issue 05-1</td>
<td>Section 4.5.3</td>
</tr>
<tr>
<td>Accounting for own-share lending arrangements in contemplation of a convertible debt issuance or other financing</td>
<td>ASU 2009-15</td>
<td>Chapter 8</td>
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The definitions of selected glossary terms from ASC 470-20-20 and the ASC master glossary are reproduced below.

<table>
<thead>
<tr>
<th><strong>ASC 470-20-20 and ASC Master Glossary</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Antidilution</strong></td>
</tr>
<tr>
<td>An increase in earnings per share amounts or a decrease in loss per share amounts.</td>
</tr>
<tr>
<td><strong>Beneficial Conversion Feature</strong></td>
</tr>
<tr>
<td>A nondetachable conversion feature that is in the money at the commitment date.</td>
</tr>
<tr>
<td><strong>Carrying Amount</strong></td>
</tr>
<tr>
<td><em>Definition 2</em></td>
</tr>
<tr>
<td>The amount of an item as displayed in the financial statements.</td>
</tr>
<tr>
<td><strong>Cashless Exercise</strong></td>
</tr>
<tr>
<td>See Net Share Settlement.</td>
</tr>
<tr>
<td><strong>Common Stock</strong></td>
</tr>
<tr>
<td>A stock that is subordinate to all other stock of the issuer. Also called common shares.</td>
</tr>
<tr>
<td><strong>Consolidated Financial Statements</strong></td>
</tr>
<tr>
<td>The financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity.</td>
</tr>
<tr>
<td><strong>Consolidated Group</strong></td>
</tr>
<tr>
<td>A parent and all its subsidiaries.</td>
</tr>
<tr>
<td><strong>Contract</strong></td>
</tr>
<tr>
<td>An agreement between two or more parties that creates enforceable rights and obligations.</td>
</tr>
<tr>
<td><strong>Conversion Rate</strong></td>
</tr>
<tr>
<td>The ratio of the number of common shares issuable upon conversion to a unit of a convertible security. For example, $100 face value of debt convertible into 5 shares of common stock would have a conversion ratio of 5:1. . . .</td>
</tr>
<tr>
<td><strong>Convertible Security</strong></td>
</tr>
<tr>
<td>A security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).</td>
</tr>
</tbody>
</table>
### ASC 470-20-20 and ASC Master Glossary (continued)

**Credit Derivative**
A derivative instrument that has both of the following characteristics:

- One or more of its underlyings are related to any of the following:
  1. The credit risk of a specified entity (or a group of entities)
  2. An index based on the credit risk of a group of entities.
- It exposes the seller to potential loss from credit-risk-related events specified in the contract.

Examples of credit derivatives include, but are not limited to, credit default swaps, credit spread options, and credit index products.

**Derecognize**
Remove previously recognized assets or liabilities from the statement of financial position.

**Derivative Instrument**
Paragraphs 815-10-15-83 through 15-139 define the term *derivative instrument*.

**Dilution**
A reduction in EPS resulting from the assumption that convertible securities were converted, that options or warrants were exercised, or that other shares were issued upon the satisfaction of certain conditions.

**Discount**
The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity.

**Down Round Feature**
A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

**Earnings per Share**
The amount of earnings attributable to each share of common stock. For convenience, the term is used to refer to either earnings or loss per share.

**Embedded Credit Derivative**
An embedded derivative that is also a credit derivative.

**Embedded Derivative**
Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.

**Equity Restructuring**
A nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.
Equity Shares
Equity shares refers only to shares that are accounted for as equity.

Face Amount
See Notional Amount.

Fair Value
Definition 2
The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Firm Commitment
Definition 2
An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. A price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a fixed price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold.

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

Financial Instrument
Cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation either:
   1. To deliver cash or another financial instrument to a second entity
   2. To exchange other financial instruments on potentially unfavorable terms with the second entity.

b. Conveys to that second entity a contractual right either:
   1. To receive cash or another financial instrument from the first entity
   2. To exchange other financial instruments on potentially favorable terms with the first entity.

The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as assets (liabilities) in financial statements — that is, they may be off-balance-sheet — because they fail to meet some other criterion for recognition.

For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.
ASC 470-20-20 and ASC Master Glossary (continued)

Freestanding Financial Instrument
A financial instrument that meets either of the following conditions:

a. It is entered into separately and apart from any of the entity’s other financial instruments or equity transactions.
b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Hybrid Instrument
A contract that embodies both an embedded derivative and a host contract.

Interest Method
The method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period.

Intrinsic Value
The amount by which the fair value of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of $20 on a stock whose current market price is $25 has an intrinsic value of $5 . . . .

Issued, Issuance, or Issuing of an Equity Instrument
An equity instrument is issued when the issuing entity receives the agreed-upon consideration, which may be cash, an enforceable right to receive cash, or another financial instrument, goods, or services. An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date or for a specified time whether to deliver the consideration or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not issued until the issuing entity has received the consideration. The grant of stock options or other equity instruments subject to vesting conditions is not considered to be issuance.

Issuer’s Equity Shares
The equity shares of any entity whose financial statements are included in the consolidated financial statements.

Mandatorily Redeemable Financial Instrument
Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

Market Participants
Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
c. They are able to enter into a transaction for the asset or liability
d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.
### ASC 470-20-20 and ASC Master Glossary (continued)

**Net Carrying Amount of Debt**
Net carrying amount of debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.

**Net Cash Settlement**
*Definition 1*
The party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged.

**Net Share Settlement**
*Definition 2*
The party with a loss delivers to the party with a gain shares with a current fair value equal to the gain.

**Noncontrolling Interest**
The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

**Notional Amount**
A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument. Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.

**Orderly Transaction**
A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

**Parent**
An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.)

**Participation Rights**
Contractual rights of security holders to receive dividends or returns from the security issuer’s profits, cash flows, or returns on investments.

**Payment Provision**
A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

**Physical Settlement**
*Definition 2*
The party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer.

**Preferred Stock**
A security that has preferential rights compared to common stock.

**Premium**
The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity. See Discount.
<table>
<thead>
<tr>
<th><strong>ASC 470-20-20 and ASC Master Glossary (continued)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Probable</strong></td>
</tr>
<tr>
<td>The future event or events are likely to occur.</td>
</tr>
<tr>
<td><strong>Public Entity</strong></td>
</tr>
<tr>
<td><strong>Definition 2</strong></td>
</tr>
<tr>
<td>An entity that meets any of the following criteria:</td>
</tr>
<tr>
<td>a. Has equity securities that trade in a public market, either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally</td>
</tr>
<tr>
<td>b. Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market</td>
</tr>
<tr>
<td>c. Is controlled by an entity covered by the preceding criteria. That is, a subsidiary of a public entity is itself a public entity.</td>
</tr>
<tr>
<td>An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is not a public entity.</td>
</tr>
<tr>
<td><strong>Reacquisition Price of Debt</strong></td>
</tr>
<tr>
<td>The amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities.</td>
</tr>
<tr>
<td><strong>Readily Convertible to Cash</strong></td>
</tr>
<tr>
<td>Assets that are readily convertible to cash have both of the following:</td>
</tr>
<tr>
<td>a. Interchangeable (fungible) units</td>
</tr>
<tr>
<td>b. Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.</td>
</tr>
<tr>
<td>(Based on paragraph 83(a) of FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises.)</td>
</tr>
<tr>
<td><strong>Reasonably Possible</strong></td>
</tr>
<tr>
<td>The chance of the future event or events occurring is more than remote but less than likely.</td>
</tr>
<tr>
<td><strong>Registration Payment Arrangement</strong></td>
</tr>
<tr>
<td>An arrangement with both of the following characteristics:</td>
</tr>
<tr>
<td>a. It specifies that the issuer will endeavor to do either of the following:</td>
</tr>
<tr>
<td>1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S. Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period</td>
</tr>
<tr>
<td>2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).</td>
</tr>
<tr>
<td>b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).</td>
</tr>
</tbody>
</table>
Related Parties
Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Security
Definition 1
The evidence of debt or ownership or a related right. It includes options and warrants as well as debt and stock.

Shares
Shares includes various forms of ownership that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Business entities have interest holders that are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are encompassed by the descriptive term owners. Equity of business entities is, thus, commonly known by several names, such as owners’ equity, stockholders’ equity, ownership, equity capital, partners’ capital, and proprietorship. Some entities (for example, mutual organizations) do not have stockholders, partners, or proprietors in the usual sense of those terms but do have participants whose interests are essentially ownership interests, residual interests, or both.

Standard Antidilution Provisions
Standard antidilution provisions are those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the value of the conversion option.

Subsidiary
An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.)

Substantive Conversion Feature
A conversion feature that is at least reasonably possible of being exercisable in the future absent the issuer’s exercise of a call option.

Time of Issuance
The date when agreement as to terms has been reached and announced, even though the agreement is subject to certain further actions, such as directors’ or stockholders’ approval.
### ASC 470-20-20 and ASC Master Glossary (continued)

**Time Value**
The portion of the fair value of an option that exceeds its intrinsic value. For example, a call option with an exercise price of $20 on a stock whose current market price is $25 has intrinsic value of $5. If the fair value of that option is $7, the time value of the option is $2 ($7 – $5).

**Transaction**
An external event involving transfer of something of value (future economic benefit) between two (or more) entities. (See FASB Concepts Statement No. 6, Elements of Financial Statements.)

**Troubled Debt Restructuring**
A restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

**Underlying**
A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument.

**Warrant**
A security that gives the holder the right to purchase shares of common stock in accordance with the terms of the instrument, usually upon payment of a specified amount.
Appendix E — Titles of Standards and Other Literature

AICPA Literature

Accounting and Valuation Guide
Valuation of Privately-Held-Company Equity Securities Issued as Compensation (2013)

Technical Questions and Answers
Section 4110, “Issuance of Capital Stock”

FASB Literature

ASC Topics
ASC 105, Generally Accepted Accounting Principles
ASC 210, Balance Sheet
ASC 250, Accounting Changes and Error Corrections
ASC 260, Earnings per Share
ASC 340, Other Assets and Deferred Costs
ASC 405, Liabilities
ASC 470, Debt
ASC 480, Distinguishing Liabilities From Equity
ASC 505, Equity
ASC 718, Compensation — Stock Compensation
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 815, Derivatives and Hedging
ASC 820, Fair Value Measurement
ASC 825, *Financial Instruments*

ASC 835, *Interest*

ASC 850, *Related Party Disclosures*

**ASUs**

ASU 2009-15, *Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing* — a consensus of the FASB Emerging Issues Task Force

ASU 2012-04, *Technical Corrections and Improvements*

ASU 2014-16, *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity* — a consensus of the FASB Emerging Issues Task Force

ASU 2015-03, *Interest — Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*

ASU 2016-06, *Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments* — a consensus of the FASB Emerging Issues Task Force

ASU 2016-19, *Technical Corrections and Improvements*

ASU 2018-07, *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*

ASU 2019-08, *Compensation — Stock Compensation (Topic 718) and Revenue From Contracts With Customers (Topic 606): Codification Improvements — Share-Based Consideration Payable to a Customer*

**Proposed ASU**

No. 2019-730, *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*

**Concepts Statements**

No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

No. 6, *Elements of Financial Statements* — a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

**Invitation to Comment**

*Agenda Consultation* (2006)

**IFRS Literature**

IAS 32, *Financial Instruments: Presentation*

**SEC Literature**

**Accounting Series Release**

ASR 268 (FRR Section 211), *Redeemable Preferred Stocks*
Exchange Act of 1934
Section 13, “Periodical and Other Reports”
Section 15(d), “Registration and Regulation of Brokers and Dealers; Supplementary and Periodic Information”

Regulation S-K
Item 303, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”

Regulation S-X
Rule 5-02, “Balance Sheets”

SAB Topics
SAB Topic 2.A, “Acquisition Method”
SAB Topic 5.A, “Expenses of Offering”

Other SEC Literature
Current Accounting and Disclosure Issues in the Division of Corporation Finance (November 2006)

Superseded Literature

AICPA Accounting Interpretation
AICPA Accounting Interpretation No. 1, Debt Tendered to Exercise Warrants, of APB Opinion No. 26 (AIN-APB 26)

APB Opinions
Opinion 14, Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants
Opinion 26, Early Extinguishment of Debt

EITF Issues and D-Topics
Issue 90-19, “Convertible Bonds With Issuer Option to Settle for Cash Upon Conversion”
Issue 98-5, “Accounting for Convertible Securities With Beneficial Conversion Features or Contingently Adjustable Conversion Ratios”
Issue 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”
Issue 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments”
Issue 02-15, “Determining Whether Certain Conversions of Convertible Debt to Equity Securities Are Within the Scope of FASB Statement No. 84”
Issue 03-7, “Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)”
Issue 05-1, “Accounting for the Conversion of an Instrument That Became Convertible Upon the Issuer’s Exercise of a Call Option”
Issue 06-6, “Debtor’s Accounting for a Modification (or Exchange) of Convertible Debt Instruments”

Issue 06-7, “Issuer’s Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133”

Issue 08-4, “Transition Guidance for Conforming Changes to Issue No. 98-5”

Issue 09-1, “Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance”

Topic D-60, “Accounting for the Issuance of Convertible Preferred Stock and Debt Securities With a Nondetachable Conversion Feature”

**FASB Staff Positions (FSP)**

FSP APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)


**FASB Statements**

No. 84, Induced Conversions of Convertible Debt (an amendment of APB Opinion No. 26)

No. 129, Disclosure of Information About Capital Structure

No. 133, Accounting for Derivative Instruments and Hedging Activities

No. 150, Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity

**FASB Technical Bulletin**

No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending Against a Takeover Attempt
Appendix F — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>AIN</td>
<td>AICPA Accounting Interpretation of an APB Opinion</td>
</tr>
<tr>
<td>APB</td>
<td>Accounting Principles Board</td>
</tr>
<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
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<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<tr>
<td>ASR</td>
<td>SEC Accounting Series Release</td>
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<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
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<tr>
<td>BCF</td>
<td>beneficial conversion feature</td>
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<tr>
<td>CCF</td>
<td>cash conversion feature</td>
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<tr>
<td>CoCo</td>
<td>contingently convertible instrument</td>
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<tr>
<td>EBITDA</td>
<td>earnings before interest, taxes, depreciation, and amortization</td>
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<tr>
<td>EITF</td>
<td>FASB Emerging Issues Task Force</td>
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<tr>
<td>EPS</td>
<td>earnings per share</td>
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<td>FAS</td>
<td>FASB Statement of Financial Accounting Standards</td>
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<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<table>
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<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>FSP</td>
<td>FASB Staff Position</td>
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<tr>
<td>FTB</td>
<td>FASB Technical Bulletin</td>
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<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<td>IPO</td>
<td>initial public offering</td>
</tr>
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<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
</tr>
<tr>
<td>MD&amp;A</td>
<td>Management’s Discussion and Analysis</td>
</tr>
<tr>
<td>OCA</td>
<td>SEC Office of the Chief Accountant</td>
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<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<td>PIK</td>
<td>paid-in-kind</td>
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<tr>
<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
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<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>TDR</td>
<td>troubled debt restructuring</td>
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Appendix G — Changes Made in the 2020 Edition of This Publication

The table below summarizes the substantive changes made to this Roadmap since the issuance of last year’s edition as a result of FASB and SEC activity and practice developments.

<table>
<thead>
<tr>
<th>Section</th>
<th>Topic</th>
<th>Description</th>
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<tbody>
<tr>
<td>Chapter 1 and 5.1, 6.1.1, 7.1</td>
<td>The FASB’s liabilities and equity project</td>
<td>Added discussion of the FASB’s project to simplify convertible debt accounting</td>
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<tr>
<td>2.8</td>
<td>Convertible debt issued to nonemployees for goods or services or as consideration payable to a customer</td>
<td>Removed the discussion of the accounting before an entity’s adoption of ASU 2018-07 and added brief discussion of ASU 2019-08</td>
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<tr>
<td>3.5.2.2.1</td>
<td>Estimated fair values exceed proceeds received</td>
<td>Expanded the discussion of the analysis of circumstances in which the fair value of the instruments issued exceeds the proceeds</td>
</tr>
<tr>
<td>3.5.3.3</td>
<td>Transactions that involve the receipt of noncash financial assets</td>
<td>Added discussion of the allocation of issuance costs when a debt issuance includes the receipt of noncash financial assets</td>
</tr>
<tr>
<td>4.5.4.1</td>
<td>Induced conversions of traditional convertible debt</td>
<td>Expanded the discussion of the application of induced conversion accounting</td>
</tr>
<tr>
<td>6.5.2</td>
<td>Induced conversions of convertible debt subject to the CCF guidance</td>
<td>Expanded the discussion of the scope of this guidance</td>
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<tr>
<td>7.3.5.1 and 7.3.5.2</td>
<td>Steps to recognize and measure any embedded BCF</td>
<td>Removed the discussion of the accounting before an entity’s adoption of ASU 2018-07</td>
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<tr>
<td>7.5.3</td>
<td>Contingent BCFs</td>
<td>Clarified that the stock price that is used to remeasure the intrinsic value is the original commitment-date stock price, not the stock price on the date the intrinsic value is remeasured, the reporting date, or the conversion date</td>
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<tr>
<td>7.5.3.2.1</td>
<td>Down-round features</td>
<td>Added discussion and examples to help distinguish between share-settled redemption features and down-round features</td>
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