Publications in Deloitte’s Roadmap Series

Business Combinations
Business Combinations — SEC Reporting Considerations
Carve-Out Transactions
Comparing IFRS Standards and U.S. GAAP
Consolidation — Identifying a Controlling Financial Interest
Contingencies, Loss Recoveries, and Guarantees
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Convertible Debt
Current Expected Credit Losses
Distinguishing Liabilities From Equity
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Preface

November 2020

To our clients, colleagues, and other friends:

We are pleased to present the inaugural edition of A Roadmap to the Issuer's Accounting for Debt, which provides an overview of the FASB's authoritative guidance on the issuer's accounting for debt arrangements as well as our insights into and interpretations of how to apply that guidance in practice.

Determining the appropriate accounting for debt arrangements can be time-consuming and complex. Terms that are significant to the accounting analysis may be buried deep within a contract's fine print. To properly apply the numerous rules in U.S. GAAP, an issuer needs to closely analyze an instrument's terms and conditions and the related facts and circumstances. The outcome of the analysis could significantly affect the classification, measurement, and earnings impact of the debt arrangement and associated financial statement ratios.

The guidance in this Roadmap is based on U.S. GAAP before the adoption of ASU 2020-06. For more information about ASU 2020-06, including its transition provisions, see Deloitte's August 5, 2020, Heads Up.

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 in applying the guidance, 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,

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Chapter 1 — Overview

This Roadmap discusses an entity’s accounting, presentation, and disclosure of (1) debt obligations, such as bonds, loans, notes, and other payables, and (2) commitments to obtain debt financing in the future, such as delayed-draw loan commitments, lines of credit, and revolving-debt arrangements. Appendix A identifies the authoritative guidance discussed in the Roadmap.

An entity that issues debt should determine how to appropriately identify units of account (see Section 3.3) and, if necessary, allocate the initial proceeds and transaction costs among those units of account (see Sections 3.4 and 3.5). The initial measurement of debt depends on whether it was issued for cash or property, goods, or services and whether the entity elects to account for the debt at fair value (see Chapter 4). The entity should also determine how to account for any fees and costs associated with debt arrangements, including commitments to obtain debt financing (see Chapter 5).

Debt is accounted for at amortized cost, and the interest method is applied (see Section 6.2), unless the issuer has elected to account for the debt at fair value (see Section 6.3). Specialized accounting models apply to certain types of debt (such as sales of future revenue, participating mortgages, indexed debt, extendable increasing-rate debt, joint-and-several obligations, and convertible debt) (see Chapter 7), and an entity needs to analyze whether debt contains any features that must be accounted for separately as derivatives (see Chapter 8).

When an entity settles, modifies, or exchanges debt, it should consider the accounting requirements related to extinguishments (see Chapter 9), modifications and exchanges (see Chapter 10), troubled debt restructurings (TDRs) (see Chapter 11), and conversions (see Chapter 12).

Most entities classify and present debt as either current or noncurrent on the face of the balance sheet (see Chapter 13). Chapter 14 discusses other considerations related to the accounting, presentation, and disclosure of debt.

Some entities are affected by both U.S. GAAP and IFRS® Standards. There are significant differences between the guidance on debt under U.S. GAAP and the equivalent requirements under IFRS Standards (see Chapter 15).

Changing Lanes

In August 2020, the FASB issued ASU 2020-06, which simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible debt instruments and contracts on an entity's own equity. The ASU removes the separation models in ASC 470-20 for convertible debt instruments with a cash conversion feature (CCF) (see Section 7.6.4) or a beneficial conversion feature (BCF) (see Section 7.6.5). It also changes 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 Section 8.4.7.6) and the method of calculating diluted earnings per share (EPS) for convertible debt instruments (see Section 14.3.3).
As a result of the ASU, an entity will not separately present embedded conversion features in equity under ASC 470-20 when initially recognizing a convertible debt instrument unless the instrument was issued at a substantial premium. However, entities would continue to separate embedded conversion options in accordance with the guidance on bifurcation of derivatives under ASC 815-15 (although the criteria for such separation is affected by the ASU’s amendments to ASC 815-40) (see Chapter 8). The ASU’s amendments are effective as follows:

- For public business entities that are not smaller reporting companies, fiscal years beginning after December 15, 2021, and interim periods within those fiscal years.
- For all other entities, fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.

The guidance may be early adopted for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years.

For convertible instruments that include a down-round feature, entities may early adopt the amendments that apply to down-round features if they have not yet adopted the amendments in ASU 2017-11.

The guidance in this Roadmap is based on U.S. GAAP before the adoption of ASU 2020-06. For more information about ASU 2020-06, including its transition provisions, see Deloitte’s August 5, 2020, Heads Up.
Chapter 2 — Scope

2.1 Background
This chapter addresses the scope of the guidance discussed in this Roadmap, including the types of entities (Section 2.2) and instruments (Section 2.3) to which it applies.

2.2 Entities
The guidance in this Roadmap applies to all entities. Generally, FASB Codification guidance (i.e., ASC guidance) applies to both public business entities (including SEC registrants) and private companies. SEC guidance applies to (1) SEC registrants and (2) private companies that either have elected to apply such guidance or are subject to it for other reasons (e.g., for the preparation of financial statements that are included or incorporated by reference in an SEC registrant’s filing).

2.3 Instruments

2.3.1 Background
This Roadmap addresses the issuer’s accounting for debt (see Section 2.3.2 below) and the potential borrower’s accounting for commitments to obtain debt financing (see Section 2.3.3), both of which represent financial instruments (see Section 2.3.4). Debt obligations are financial liabilities (see Section 2.3.5). Sections 2.3.2.4 and 2.3.6 identify topics that are beyond the scope of this Roadmap.

2.3.2 Debt

2.3.2.1 General

ASC 835-30

15-2 The guidance in this Subtopic applies to receivables and payables that represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest, with certain exceptions noted below. Such receivables and payables are collectively referred to in this Subtopic as notes. Some examples are the following:

a. Secured and unsecured notes
b. Debentures
c. Bonds
d. Mortgage notes
e. Equipment obligations
f. Some accounts receivable and payable.
The types of debt addressed in this Roadmap include loans, bonds, notes, and other kinds of debt securities and payables. In a manner generally similar to the description of a “note” in ASC 835-30-15-2 and “debt” in ASC 470-60-15-4A, the Roadmap uses the term “debt” to describe contractual obligations to pay money on demand or on fixed or determinable dates irrespective of whether such obligations contain any stated provision for interest.

### Changing Lanes

The definition of “debt” in the ASC master glossary used to be similar to the description of a note in ASC 835-30-15-2, except for a specific reference to restructuring situations. In 2016, the FASB concluded that this description was not “robust enough” in contexts other than TDRs and, upon issuing ASU 2016-19, removed the definition. In September 2019, the FASB issued a proposed ASU that would add to the ASC master glossary the definition of “debt arrangement,” which would be as follows: “An arrangement that provides a lender with a contractual right to receive consideration and a borrower with a contractual obligation to pay consideration on demand or on fixed or determinable dates.” The proposed ASU has not been finalized and, as of the issuance of this Roadmap, the related project is still on the FASB’s technical agenda.

The scope of this Roadmap is limited to the accounting by the party that has a contractual obligation (liability) to pay the debt. The terms that describe such a party — including issuer, debtor, borrower, or obligor — are used interchangeably in the Roadmap unless otherwise specified. The Roadmap does not address the accounting by the party that has a contractual right (asset) to collect the debt (i.e., the party described as the holder, creditor, lender, investor, or finance provider).

An instrument that represents a legal-form debt obligation should be accounted for as debt even if it has certain economic characteristics that are similar to those of an equity instrument, such as perpetual debt. For example, an instrument that represents a legal-form debt obligation in the jurisdiction in which it is issued and carries creditor rights (e.g., an ability to seek recourse in a bankruptcy court) should be accounted for as debt even if the issuer only has a de minimis amount of common equity capital and the instrument (1) is described as an “equity certificate,” (2) has a long maturity (e.g., 40 years), (3) is subordinated to all other creditors, (4) contains conversion rights into common equity, and (5) provides dividend rights that are similar to those of a holder of common equity (e.g., payable only if declared). If it is not readily apparent whether a claim on an entity legally represents debt or equity, the entity may need to seek advice from legal counsel.

### 2.3.2.2 Convertible Debt

Convertible debt is debt that contains a feature that requires or permits its conversion into the issuer’s equity shares. Although this Roadmap discusses and broadly applies to convertible debt, it does not comprehensively address the specialized accounting requirements in ASC 470-20 related to the separate presentation of equity components in certain types of such debt. For an overview of those requirements, see Section 7.6. For a comprehensive discussion, see Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt.*
2.3.2.3 **Share-Settled Debt**

**ASC 480-10**

25-14 A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a condition obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer’s equity shares)

b. Variations in something other than the fair value of the issuer’s equity shares (for example, a financial instrument indexed to the Standard and Poor’s S&P 500 Index and settleable with a variable number of the issuer’s equity shares)

c. Variations inversely related to changes in the fair value of the issuer’s equity shares (for example, a written put option that could be net share settled).

Under ASC 480-10, liability classification is required for outstanding financial instruments that embody an unconditional obligation — or for outstanding financial instruments other than outstanding shares that embody a conditional obligation — that the issuer must or may settle by issuing a variable number of its equity shares if the obligation’s monetary value is based solely or predominantly on one of the following: (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer’s equity shares, or (3) variations inversely related to changes in the fair value of the issuer’s equity shares (see Chapter 6 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*).

Outstanding financial instruments that are classified as liabilities under ASC 480-10-25-14(a) are often described as share-settled debt even if they do not represent legal-form debt (e.g., because of an absence of creditor rights). If the monetary value of such obligations represents a fixed or predominantly fixed monetary amount known at inception, the obligations should be accounted for in a manner similar to legal-form debt as discussed in this Roadmap (i.e., in accordance with the interest method in ASC 835-30 unless the fair value option in ASC 825-10 is elected; see Chapter 6). As noted in paragraph B13 of the Background Information and Basis for Conclusions of FASB Statement 150, “a financial instrument that requires settlement by issuance of $100,000 worth of equity shares establishes something more akin to a debtor-creditor relationship than to an ownership relationship.”

Other variable-share obligations that are liabilities under ASC 480-10-25-14(b) and (c) must be accounted for at fair value under ASC 480-10-35-5. However, the last sentence of ASC 480-10-55-22 implicitly acknowledges that a fixed-monetary-value share-settled debt arrangement does not need to be measured at fair value through earnings under ASC 480-10. ASC 480-10-55-22 addresses whether an entity should recognize a gain or loss related to the difference between the average and ending market price upon the settlement of a share-settled debt arrangement for which the entity used an average stock price rather than the ending stock price to determine the number of shares that will be delivered. If the instrument described in ASC 480-10-55-22 had been measured on an ongoing basis at fair value (i.e., on the basis of a current stock price), there would have been no difference to address at settlement after the issuer had updated its prior fair value estimate. Since these types of liabilities are accounted for at amortized cost (when the fair value option has not been elected), they are addressed in this Roadmap.

For a comprehensive discussion of the classification and measurement requirements in ASC 480-10, see Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*.

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1 However, some legal-form debt instruments contain conditional share-settled obligations that must be separated as embedded derivatives under ASC 815-15.
2.3.2.4 Certain Obligations With Characteristics Similar to Debt

This Roadmap does not directly, comprehensively address all of the accounting requirements for the following types of liability-classified instruments:

- Liabilities for product financing arrangements within the scope of ASC 470-40, such as contracts in which an entity arranges for another entity to purchase a product on its behalf and agrees to purchase the product from that other entity (see ASC 470-40-05-2(b)). However, the Roadmap's guidance would generally be relevant to such liabilities because ASC 470-40 does not provide specific requirements related to their subsequent measurement other than to state that they must be accounted for as borrowings (see ASC 470-40-25-1).

- Mandatorily redeemable financial instruments that are classified as liabilities under ASC 480-10-25-4. For a discussion of the accounting for such liabilities, see Chapter 4 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity.

- Instruments that embody an obligation to deliver a variable number of shares and are classified as liabilities under ASC 480-10-25-14(b) and (c). For a discussion of the accounting for such liabilities, see Chapter 6 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity. The guidance in this Roadmap is relevant to the accounting for share-settled debt that is classified as a liability under ASC 480-10-25-14(a) (see Section 2.3.2.3).

- Liabilities for repurchase agreements with customers that are within the scope of ASC 606. For a discussion of the accounting guidance for such agreements, see Deloitte's A Roadmap to Applying the New Revenue Recognition Standard. The guidance in this Roadmap may be relevant to financial liabilities recognized under ASC 606-10-55-70.

- Liabilities of collateralized financing entities, which are addressed in ASC 810 and ASC 825. For a discussion of the accounting for such liabilities, see Sections 10.1.3 and 10.2.2 of Deloitte's A Roadmap to Consolidation — Identifying a Controlling Financial Interest and Section 12.4.1.2.2.1.1 of Deloitte's A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option).

- Financial liabilities recognized under leases within the scope of ASC 842. For a discussion of that guidance, see Deloitte's A Roadmap to Applying the New Leasing Standard.

- Secured borrowings that are recognized under ASC 860-30-25-2 upon a transfer of financial assets that does not meet the conditions for sale accounting in ASC 860-10-40-5. However, the Roadmap's guidance would generally be relevant to such liabilities because ASC 860-30 does not specify the manner in which they are subsequently measured and instead requires entities to measure them in accordance with other relevant accounting guidance (see ASC 860-30-35-3).

- Deposit liabilities of depository institutions, which are addressed in ASC 942-405 and ASC 942-470.

- Obligations incurred in short sales, which are addressed in ASC 815-10-55-57 through 55-59 and ASC 942-405-25-1.
2.3.3 Loan Commitments

**ASC Master Glossary**

**Loan Commitment**

Loan commitments are legally binding commitments to extend credit to a counterparty under certain prespecified terms and conditions. They have fixed expiration dates and may either be fixed-rate or variable-rate. Loan commitments can either be either of the following:

a. **Revolving** (in which the amount of the overall line of credit is reestablished upon repayment of previously drawn amounts)

b. **Nonrevolving** (in which the amount of the overall line of credit is not reestablished upon repayment of previously drawn amounts).

Loan commitments can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower. Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement. This is not an authoritative or all-encompassing definition.

**Note:** The following definition is Pending Content; see Transition Guidance in 326-10-65-1.

Loan commitments are legally binding commitments to extend credit to a counterparty under certain prespecified terms and conditions. They have fixed expiration dates and may either be fixed-rate or variable-rate. Loan commitments can be either of the following:

a. **Revolving** (in which the amount of the overall commitment is reestablished upon repayment of previously drawn amounts)

b. **Nonrevolving** (in which the amount of the overall commitment is not reestablished upon repayment of previously drawn amounts).

Loan commitments can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower. Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement.

**ASC 835-30-S20 — Glossary**

**Line-of-Credit Arrangement**

A line-of-credit or revolving-debt arrangement is an agreement that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then reborrow under the same contract. Line-of-credit and revolving-debt arrangements may include both amounts drawn by the debtor (a debt instrument) and a commitment by the creditor to make additional amounts available to the debtor under predefined terms (a loan commitment).

In addition to the issuer’s accounting for debt, this Roadmap addresses the potential borrower’s accounting for loan commitments, including line-of-credit arrangements, revolving-debt arrangements, delayed-draw term loan commitments, and commitments to issue debt securities. The contractual terms of loan commitments may specify the timing and amount of the debt that the entity might draw, conditions that must be met to draw down committed amounts (e.g., financial or operational conditions, such as the satisfaction of business milestones), the applicable interest rate or index, and repayment terms.
Loan commitments are either revolving or nonrevolving:

- **Nonrevolving loan commitment (including delayed-draw debt and term loan commitments)** — Once a funded loan has been repaid, those amounts cannot be reborrowed. Some nonrevolving loan commitments involve multiple tranches. For example, a tranche financing agreement might involve the issuance of an initial tranche of term debt that is funded when the contract is executed and one or more future tranches of committed term debt that will be funded on future closing dates.

- **Revolving loan commitment (including line-of-credit or revolving-debt arrangements)** — Repaid amounts can be reborrowed. That is, the potential debtor can make multiple borrowings up to a specified maximum amount, repay borrowed amounts, and reborrow.

The potential debtor’s accounting for loan commitments tends to center on (1) the treatment of any costs and fees that an entity has incurred to obtain such commitments (see Chapter 5), (2) the accounting for modifications and exchanges of commitments (see Section 10.6), and (3) the impact of the existence of commitments on the classification of debt as current or noncurrent in a classified balance sheet (see Section 13.7). Further, the potential debtor should consider whether to account for a freestanding loan commitment as a derivative (see below). When a credit facility or tranche debt financing arrangement includes both drawn and undrawn components, the debtor should also appropriately identify the units of account (e.g., whether commitments to obtain additional term loans on future closing dates represent freestanding financial instruments or features embedded in a debt host contract; see Section 3.3). If a term loan commitment is embedded in a debt host contract, the debtor should evaluate whether the commitment should be separated as a derivative (see Section 8.4.6).

In many cases, a commitment to obtain debt financing is exempt from derivative accounting under ASC 815, even if it meets the characteristics of a derivative in ASC 810-10-15-83, because ASC 815-10-15-69 specifies that ASC 815-10 does not apply to the holder’s (i.e., potential borrower’s) accounting for “a commitment to originate a loan.” This scope exception applies irrespective of whether (1) the commitment is conditional or (2) the loan is revolving or nonrevolving. Further, it applies even if the funding will be in the form of a debt security. ASC 310-10-20 defines a loan as “[a] contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor’s statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable.” The application of this scope exception to commitments to issue debt securities was informally discussed with members of the SEC staff, who concurred that it may be applied to an entity’s commitment to receive funds in exchange for the initial issuance of a debt security that will be an obligation of the entity.

### Example 2-1

**Application of Loan Commitment Scope Exception to Issuance of Debt Securities**

On July 1, 20X1, Entity E enters into an agreement to issue medium term note debt securities to Purchaser P. On that date, all terms of the securities are negotiated with P, including the settlement date of August 1, 20X1. Once the medium term note debt securities are issued, it is expected that they will be actively traded in a liquid market. Although the commitment to issue the securities meets the characteristics of a derivative in ASC 810-10-15-83, it qualifies for the scope exception in ASC 815-10-15-69. Accordingly, E will not account for its commitment as a derivative.
In a typical loan commitment, the potential creditor writes an option to the potential debtor that permits the potential debtor to obtain debt on prespecified terms at its request. Therefore, the loan commitment scope exception does not apply to an option written by the potential debtor to the potential creditor under which the potential debtor (1) could be forced by the potential creditor to enter into a loan but (2) is not given a right to elect to borrow money from the potential creditor.

ASC 815 does not clearly address whether the scope exception for loan commitments is available if the loan to be funded contains an embedded feature that will require bifurcation as a derivative once the funding takes place (see Chapter 8). It may therefore be prudent to further evaluate whether the commitment for such loans meets the definition of a derivative in ASC 815. If the loan commitment does not meet the net settlement characteristic in the definition of a derivative (e.g., it requires delivery of an underlying loan that is not readily convertible to cash, and the commitment cannot otherwise be net settled), the debtor may conclude that the loan commitment should not be accounted for as a derivative even if the scope exception for loan commitments is considered inapplicable.

### 2.3.4 Financial Instruments

<table>
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<th>ASC Master Glossary</th>
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<tbody>
<tr>
<td><strong>Financial Instrument</strong></td>
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<tr>
<td>Cash, evidence of an ownership interest in an entity, or a contract that both:</td>
</tr>
<tr>
<td>a. Imposes on one entity a contractual obligation either:</td>
</tr>
<tr>
<td>1. To deliver cash or another financial instrument to a second entity</td>
</tr>
<tr>
<td>2. To exchange other financial instruments on potentially unfavorable terms with the second entity.</td>
</tr>
<tr>
<td>b. Conveys to that second entity a contractual right either:</td>
</tr>
<tr>
<td>1. To receive cash or another financial instrument from the first entity</td>
</tr>
<tr>
<td>2. To exchange other financial instruments on potentially favorable terms with the first entity.</td>
</tr>
</tbody>
</table>

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.

Both outstanding debt and loan commitments meet the FASB's definition of a financial instrument. They each represent a contract that “[i]mposes on one entity a contractual obligation . . . to deliver cash or another financial instrument to a second entity [and] conveys to that second entity a contractual right . . . to receive cash or another financial instrument from the first entity.” Accordingly, both debt and loan commitments are included within the scope of Codification guidance that specifies that it applies to financial instruments (e.g., the fair value measurement disclosure requirements in ASC 825-10; see Section 14.4.10) unless that guidance specifically exempts them.
The definition of a financial instrument contemplates that contractual rights and contractual obligations may be “conditioned on the occurrence of a specified event.” Therefore, a loan commitment meets the definition of a financial instrument even if the funding of the loan is elective or conditional (e.g., upon the achievement of specified business milestones).

This Roadmap does not address the accounting for items that do not meet the definition of a financial instrument, including:

- Noncontractual rights or obligations, such as an obligation to pay taxes imposed by a government.
- Contractual rights or obligations that involve the receipt or delivery of nonfinancial items (e.g., an obligation to deliver goods or services, property, plant, equipment, or intangible assets).

### 2.3.5 Financial Liabilities

<table>
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<th>ASC Master Glossary</th>
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<tbody>
<tr>
<td><strong>Financial Liability</strong></td>
</tr>
<tr>
<td>A contract that imposes on one entity an obligation to do either of the following:</td>
</tr>
<tr>
<td>a. Deliver cash or another financial instrument to a second entity</td>
</tr>
<tr>
<td>b. Exchange other financial instruments on potentially unfavorable terms with the second entity.</td>
</tr>
</tbody>
</table>

From the issuer’s perspective, debt meets the FASB’s definition of a financial liability because it is a “contract that imposes on one entity an obligation to . . . deliver cash or another financial instrument to a second entity.” Accordingly, debt is included within the scope of Codification guidance that specifies that it applies to financial liabilities (e.g., the presentation of changes in fair value attributable to instrument-specific credit risk of liabilities for which the fair value option in ASC 825-10 has been elected; see Section 6.3.2) unless that guidance provides a specific exemption. A loan commitment that gives the holder a right but does not obligate it to obtain a loan does not meet the definition of a financial liability. This Roadmap does not address the accounting for (1) financial liabilities other than debt or (2) obligations that do not meet the definition of a financial liability.

### 2.3.6 Topics That Are Beyond the Scope of This Roadmap

While an entity may need to consider guidance on the following topics when it accounts for debt, a detailed discussion of them is beyond the scope of this Roadmap:

- Hedge accounting (see Section 14.2.1).
- Fair value measurements (see Section 14.2.2 and Deloitte’s *A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option)*).
- Foreign currency matters (see Section 14.2.3 and Deloitte’s *A Roadmap to Foreign Currency Transactions and Translations*).
- Capitalization of interest (see Section 14.2.4).
- Reference rate reform (see Section 14.2.5).
- Balance sheet offsetting (see Section 14.3.1.1).
- The preparation of the statement of cash flows (see Section 14.3.2 and Deloitte’s *A Roadmap to the Preparation of the Statement of Cash Flows*).
• The presentation and disclosure of EPS (see Section 14.3.3 and Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*).

• Business combinations (see Deloitte’s *A Roadmap to Accounting for Business Combinations*).

• Consolidation (see Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*).

• Specialized industry guidance.

Further, the guidance in this Roadmap does not apply to the accounting for the following liabilities or equity items:

• Asset retirement and environmental obligations within the scope of ASC 410 (see Deloitte’s *A Roadmap to Accounting for Environmental Obligations and Asset Retirement Obligations*).

• Exit or disposal cost obligations within the scope of ASC 420.

• Deferred revenue within the scope of ASC 430.

• Unconditional purchase obligations and certain other commitments issued within the scope of ASC 440.

• Loss contingencies within the scope of ASC 450 (see Deloitte’s *A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees*).

• Guarantee obligations within the scope of ASC 460 (see Deloitte’s *A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees*).

• Equity-classified items within the scope of ASC 505.

• Contract liabilities within the scope of ASC 606 (see Deloitte’s *A Roadmap to Applying the New Revenue Recognition Standard*).

• Employee benefit obligations within the scope of ASC 712, ASC 715, ASC 960, or ASC 962.

• Share-based payments for goods or services within the scope of ASC 718 (see Deloitte’s *A Roadmap to Accounting for Share-Based Payment Awards*).

• Tax obligations within the scope of ASC 740 (see Deloitte’s *A Roadmap to Accounting for Income Taxes*).

• Freestanding derivative contracts within the scope of ASC 815.

• Servicing liabilities within the scope of ASC 860-50.

• Insurance liabilities within the scope of ASC 944.
Chapter 3 — Contract Analysis

3.1 Background
This chapter discusses how an entity should identify and evaluate contractual terms (see Section 3.2 below) and units of account (see Section 3.3) as well as the allocation of debt proceeds and issuance costs to those units of account (see Sections 3.4 and 3.5, respectively).

3.2 Identifying and Evaluating Contractual Terms
When determining the appropriate accounting for a debt transaction, an entity should carefully review the underlying legal documents and consider all relevant facts and circumstances. It also needs to consider the numerous rules and exceptions that exist under GAAP and that might apply to the transaction. Sometimes seemingly simple debt transactions raise complex accounting issues.

Since the details of debt transactions tend to be unique, an entity cannot assume that it can use the same accounting that it or other entities used for other similar transactions. For example, the allocation of proceeds to other contemporaneous transactions could affect the analysis of whether any embedded features need to be bifurcated (see Chapter 8). Likewise, the analysis of the appropriate accounting for a debt modification depends on whether the issuer is experiencing financial difficulties and has received a concession from the creditor (see Chapter 11).

Further, contractual terms that may be significant to the accounting analysis could be buried deep within a contract’s fine print, or they may have been overridden or modified in separate legal documents (e.g., confidential side letters). Even minor variations in the way contractual terms are defined could have a material effect on the accounting for a debt arrangement. For example, the accounting analysis of a provision that requires an increase to the interest rate of a debt instrument upon the debtor’s event of default depends on how the contractual terms define an event of default (see Section 8.4.2).

In forming a view on the appropriate accounting, an entity should not rely solely on the name given to a transaction or how it is described in summary term sheets, slideshow presentations, or 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.

An entity should also be mindful that 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. For example, an equity conversion feature that is embedded in a debt arrangement and economically represents a share-settled redemption feature might need to be analyzed as a redemption feature even though its form is that of a conversion feature (see Section 8.4.7.2.5).

The determination of the appropriate accounting for a debt arrangement can be time-consuming and complex. The outcome of the analysis could significantly affect the arrangement’s classification,
measurement, and earnings impact as well as its associated financial statement ratios. To arrive at appropriate accounting conclusions, an entity should work with its auditors and consider involving technical specialists.

3.3 Units of Account

3.3.1 Background

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

In determining the appropriate accounting for a debt transaction, an entity should consider how to identify units of account (i.e., the “level at which an asset or a liability is aggregated or disaggregated”). While many debt contracts represent one unit of account, some legal agreements consist of two or more components that individually represent separate units of account (e.g., debt with detachable warrants). Conversely, two separate agreements might represent one combined unit of account (e.g., debt that was issued with warrants that are not legally detachable or separately exercisable from the debt).

Example 3-1

**Debt Issued With Other Financial Instruments**

Entity B enters into a credit facility with Entity C under which it receives an initial term loan of $20 million and term loan commitments that permit B to request up to an additional $100 million of term loans on specified dates in the future if certain conditions are met. In addition to the payment of principal and interest on outstanding term loans, the credit facility requires B to make payments to C that are indexed to B's sales revenue. In conjunction with the transaction, B issues warrants to C on its own stock worth $10 million for no separate consideration.

Entity B must determine whether the transaction consists of one or more units of account, including whether the term loan commitments, the warrants, and the revenue-indexed payment obligation are embedded in the initial term loan or should be treated as units of account that are separate from the initial term loan.

To determine the units of account, an issuer should identify each freestanding financial instrument (see Section 3.3.2 below) and any other elements that qualify for separate accounting recognition (see Section 3.3.3).

3.3.2 Freestanding Financial Instruments

3.3.2.1 Framework for Identifying Freestanding Financial Instruments

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freestanding Financial Instrument</td>
</tr>
<tr>
<td>A financial instrument that meets either of the following conditions:</td>
</tr>
<tr>
<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>b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.</td>
</tr>
</tbody>
</table>
In identifying units of account, an entity should consider the definition of a freestanding financial instrument in ASC 480-10 and other relevant guidance. (Note that the definition of a freestanding contract in ASC 815-40 is substantially equivalent to the definition of a freestanding financial instrument in ASC 480-10.)

ASC 480-10-20 defines a freestanding financial instrument as one that is entered into either “separately and apart from any of the entity's other financial instruments or equity transactions” or “in conjunction with some other transaction and is legally detachable and separately exercisable.” Therefore, in identifying freestanding financial instruments, an entity should consider the following questions, each of which is discussed in detail in the sections below:

- Was the transaction entered into contemporaneously with and in contemplation of another transaction, or was it entered into separately and apart from other transactions?
- Is the item legally detachable?
- Can the item be exercised separately, or does exercise result in the termination, redemption, or automatic exercise of a specifically identified item?
- Does the transaction involve multiple counterparties?

3.3.2.1.1 Contemporaneous or Separate Transaction
The fact that a transaction was entered into separately and apart from any other transaction suggests that it is a freestanding financial instrument. If the transaction was entered into contemporaneously with and in contemplation of another transaction, the entity should assess whether the two transactions represent a single freestanding financial instrument. For example, if an entity issues warrants in conjunction with debt, it should consider whether to treat the warrants as being embedded in the debt even if they are subject to a separate contractual agreement.

The fact that a transaction was entered into contemporaneously or in conjunction with some other transaction, however, would not necessarily result in a conclusion that the two transactions should be viewed on a combined basis as a single freestanding financial instrument. The entity should also consider whether the transactions are legally detachable and separately exercisable (see Section 3.3.2.1.2 below) and whether the combination guidance in ASC 815-10 applies (see Section 3.3.2.2).

A one-week period between transactions may be sufficient evidence that two transactions are not contemporaneous if the entity is exposed to market fluctuations during this time. Even when transactions occur at different times, entities should consider all available evidence to ensure that no side agreements or other contracts were entered into that suggest that the transactions were entered into in contemplation of one another.

3.3.2.1.2 Legally Detachable
Neither ASC 480 nor other GAAP provide guidance on the meaning of “legally detachable.” We believe that a presumption exists that to be legally detachable from another item, an item must be separately transferable from that item. If an item is separately exercisable but not considered legally detachable, it would not be a separate freestanding financial instrument under item (b) of the definition of a freestanding financial instrument.

An item is considered “legally detachable” if it can be transferred separately from another item in a single contractual agreement (or from another item in multiple contracts entered into at the same time) at the holder’s discretion (i.e., without limitations imposed by the counterparty). The fact that an item can be transferred independently from another item indicates that it is a separate unit of account even
if the two items were entered into contemporaneously and have the same counterparty. This view is supported by the guidance in ASC 815-10-25-9, which states, in part:

Derivative instruments that are transferable are, by their nature, separate and distinct contracts.

Similarly, ASC 815-10-15-5 states, in part:

The notion of an embedded derivative . . . does not contemplate features that may be sold or traded separately from the contract in which those rights and obligations are embedded. Assuming they meet [the] definition of a derivative instrument, such features shall be considered attached freestanding derivative instruments rather than embedded derivatives by both the writer and the current holder.

### Example 3-2

**Debt Issued With Additional Term Loan Commitments**

Entity A enters into an agreement with a lender for the issuance of a term loan facility in an aggregate principal amount of up to $65 million. The agreement specifies the issuance of a term loan advance of $15 million at the agreement's closing. Additional term loan advances are available to A as follows:

- Upon achieving a specified milestone target and before six months after closing, A may request an additional term loan advance from the lender of $10 million.
- Upon achieving an incremental milestone target and before one year after closing, A may request an additional term loan advance from the lender of $20 million.
- Upon achieving another milestone target and before two years after closing, A may request an additional term loan advance from the lender of up to $20 million, in minimum increments of $5 million.

If there is no restriction preventing the lender from selling, to a third party, a term loan tranche that it has already provided to A, and the lender continues to be contingently obligated to provide subsequent tranches of additional term loan advances to A upon A's request, the future tranches would be analyzed as freestanding financial instruments (e.g., loan commitments) that are separate from the initial tranche. This is the case even though the loan facility is documented in a single agreement. Note that B should therefore allocate a portion of the proceeds received in the initial closing of the agreement to the three future tranches (i.e., some of the $15 million received at closing may be attributable to the three future tranches).

However, a scenario in which two items cannot be transferred independently of one another suggests that each item is not a freestanding financial instrument under item (b) in the definition of a freestanding financial instrument. For example, if a warrant “travels with” a bond and cannot be transferred separately from the bond, it may be an embedded feature in the bond.

A contract may be entered into in conjunction with some other item. Before such a contract can be considered a freestanding instrument, an assessment must be performed of both the form and substance of the transaction, including the substance of the independent transferability of the item. In some circumstances, an item is unconditionally separately transferable by the holder but would have no economic value if the related item were not held, which would suggest that the separate transferability has no substance and the item is embedded in the related item (see further discussion in Section 3.3.2.1.3). Similarly, the holder of a debt instrument that is not readily obtainable in the market may have a separately transferable put option that it can exercise only by delivering the same specific instrument. In this case, the debt and the put option may represent a single, combined unit of account on the basis of an assessment of the substance of the transaction.

In other circumstances, an item may be separately transferred only with the consent of the counterparty. If an item may be separated from a related contract without any modification to the contractual terms (e.g., the contract specifically permits the item to be transferred if the issuer gives its consent and such consent cannot be unreasonably withheld), the legally detachable condition is, in substance, generally met since the counterparty has agreed not to withhold its consent. If, however, the counterparty can always prevent the separate transfer of the item at its discretion, the legally detachable
condition is, in substance, most likely not met and therefore the item is not a freestanding financial instrument.

**Example 3-3**

**Bond Issued With Warrants**

An entity issues a bond with a warrant. The agreement specifies that the counterparty may not transfer the bond or the warrant without the issuer's consent. However, the agreement does not preclude the transfer of the warrant separately from the bond if the issuer were to give its consent. Further, the contract specifies that such consent cannot be unreasonably withheld. The exercise of the warrant does not result in the termination of the bond (i.e., the counterparty is not required to tender the bond as payment of the exercise price of the warrant). In these circumstances, the warrant is considered a freestanding financial instrument because it is both independently transferable and separately exercisable. The fact that the warrant contains a restriction that may preclude the counterparty from transferring it does not mean that the warrant is not a freestanding contract since the contract specifies that the issuer's consent cannot be unreasonably withheld.

The SEC staff has indicated in informal discussions that it is possible, although not common, for two items that have been entered into contemporaneously with the same counterparty to be considered freestanding financial instruments solely on the basis of the items' ability to be separately exercised (i.e., even though the contractual terms prevent the items from being transferred separately). This would generally be the case when a reasonable conclusion can be reached that the separate exercisability of one item is sufficient to establish that it is legally detachable from the related item. However, when determining whether an item can be transferred separately, an entity must use significant judgment and consider the transaction's form and substance. We therefore strongly recommend that an entity consult with its independent accounting advisers when performing this assessment.

**Example 3-4**

**Tranche Debt Financing Agreement**

Entity X enters into a tranche debt financing agreement with unrelated investors to sell two tranches of convertible debt. The purchase agreement stipulates the following:

- On the first closing date, which is the date of the purchase agreement, the investors will purchase $50 million of convertible debt.
- On the second closing date, the investors will purchase $25 million of convertible debt subject to a specified condition. The second closing will occur only if (1) a specific milestone related to X's operations is achieved two years from the first closing date or (2) the specific milestone related to X's operations is not achieved two years from the first closing date but the holders waive the milestone requirement and elect to purchase the convertible debt (the “contingent purchase option”).
- The holders of convertible debt issued in the first closing cannot transfer their contingent purchase options separately from the convertible debt acquired in the first closing (or vice versa). However, such holders have the right to convert that debt into common stock before the date that is two years from the first closing date.
- The holders that convert debt into common stock may sell those common shares, and the only restrictions on selling common stock stem from restrictions under U.S. securities laws.
Example 3-4 (continued)

In this example, the contingent purchase option would be considered a freestanding financial instrument because it meets the “legally detachable and separately exercisable” condition. While the contingent purchase option cannot be legally detached from the debt, the holders can, in substance, “detach” the two instruments because they can convert the debt into common stock and sell those shares while retaining the contingent purchase option. This would be the case even if the contingent purchase option may not be separately transferred after the conversion into common stock of the debt obtained in the first closing. It would not be appropriate to consider the debt and the contingent purchase option a single combined financial instrument because the contingent purchase option would not become embedded in the common shares received upon conversion of the debt purchased in the first closing. Note that the above conclusion would not change if the holders were restricted from selling the common shares received upon conversion of the debt because, as stated above, the contingent purchase option would not become embedded in the common shares received when the debt purchased in the first closing is converted.

3.3.2.1.3 Separate Exercise Versus Termination, Redemption, or Automatic Exercise

If an item can be freely exercised without terminating another item (e.g., through redemption, automatic exercise, or expiration), it is considered to be “separately exercisable.” For example, the fact that a warrant remains outstanding if a bond to which it is attached is redeemed suggests that the warrant is a freestanding financial instrument that is separate from the bond. Similarly, if a bond may remain outstanding after a net-share-settled conversion feature included in the bond is exercised, the conversion feature may be a freestanding financial instrument.

Conversely, if the exercise of an item results in the termination of a specifically identified item, the first item would not be considered separately exercisable from the other item. For example, if a warrant can be exercised only by the tendering of a specific bond in a physical settlement, the warrant may be a feature embedded in the bond rather than a freestanding financial instrument. ASC 470-20-25-3 states, in part:

> [I]f stock purchase warrants are not detachable from [a] 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.

3.3.2.1.4 Multiple Counterparties

Contracts with different counterparties are treated as separate freestanding financial instruments even if they were issued contemporaneously or were transacted as a package. ASC 815-10-15-6 suggests that an option added or attached to an existing debt instrument by another party is not an embedded derivative because it does not have the same counterparty. Similarly, ASC 815-15-25-2 indicates that the notion of an embedded derivative in a hybrid instrument does not refer to provisions in separate contracts between separate counterparties.

Example 3-5

**Bonds and Warrants Issued to Underwriter**

An entity delivers a bond and a warrant on its own equity to an underwriter for cash. The underwriter is a party to the warrant but holds the bond merely as an agent for a third-party investor. The terms and pricing of the bond sold to the third-party investor are not affected by the sale of the warrant to the underwriter. Because they involve different counterparties, the bond and the warrant are two separate freestanding financial instruments.
Under ASC 815-10-25-10, transactions that are entered into with a single party are treated as having the same counterparty even if some of them are structured through an intermediary (see Section 10.5.2). In consolidated financial statements, the reporting entity is the consolidated group. Therefore, the parent and its subsidiary would not be considered different parties in the consolidated financial statements. For example, if a parent entity writes a put option on debt issued by the subsidiary, it is acceptable to view the option as being embedded in the debt in the consolidated financial statements even though the subsidiary technically is not a party to the option.

### 3.3.2.2 Combination Guidance

ASC 815-10 contains additional guidance to help an entity determine whether two or more separate transactions should be viewed as separate units of account or combined for accounting purposes. ASC 815-10-15-8 states, in part:

> In some circumstances, an entity could enter into two or more legally separate transactions that, if combined, would generate a result that is economically similar to entering into a single transaction that would be accounted for as a derivative instrument under this Subtopic.

Nevertheless, ASC 815 ordinarily does not permit an entity to treat two or more freestanding financial instruments as a single combined unit of account. Derivatives Implementation Group Issue F6 (not codified) notes the following:

> [ASC 815] is a transaction-based standard.

Similarly, ASC 815-10-25-6 states, in part:

> [ASC 815-10] generally does not provide for the combination of separate financial instruments to be evaluated as a unit.

However, if two or more freestanding financial instruments have characteristics suggesting that they were structured to circumvent GAAP (e.g., two offsetting debt instruments that in combination represent an interest rate swap), they may need to be combined and treated as a single unit of account. Specifically, ASC 815-10 requires two or more separate transactions to be combined and viewed in combination as a single unit of account if they were entered into in an attempt to circumvent the accounting requirements for derivatives (i.e., measured at fair value, with subsequent changes in fair value recognized in earnings except for qualifying hedging instruments in cash flow or net investment hedges). In accordance with ASC 815-10-15-9, such transactions must be combined if they have all of the following characteristics:

- They “were entered into contemporaneously and in contemplation of one another.”
- They “were executed with the same counterparty (or structured through an intermediary).”
- They “relate to the same risk” (e.g., the fair value of the issuer’s equity shares).
- “There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.”

ASC 815-10-25-6 identifies characteristics similar to those listed above and also notes the following:

> If separate derivative instruments have all of [these] characteristics, judgment shall be applied to determine whether the separate derivative instruments have been entered into in lieu of a structured transaction in an effort to circumvent GAAP. . . . If such a determination is made, the derivative instruments shall be viewed as a unit.

ASC 815 does not specify a period of separation between transactions (e.g., one day, one week) that would disqualify them from being treated as contemporaneous. A one-week period between transactions may be sufficient evidence that the transactions are not contemporaneous if the entity is
exposed to market fluctuations during this time. Thus, even when transactions occur at different times, entities must consider all available evidence to ensure that no side agreements or other contracts were entered into that call into question whether the transactions were contemporaneous (e.g., there are no earlier agreements for trades to be entered into simultaneously).

ASC 815-10 contains the example below of two offsetting loans that would be combined and accounted for as one unit of account.

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**ASC 815-10**

**Example 19: Recognition — Viewing Separate Transactions as a Unit for Purposes of Evaluating Net Settlement**

**Case B: Borrowing and Lending Transactions Viewed as a Unit**

55-179 Entity C loans $100 to Entity B. The loan has a 5-year bullet maturity and an 8 percent fixed interest rate, payable semiannually. Entity B simultaneously loans $100 to Entity C. The loan has a five-year bullet maturity and a variable interest of LIBOR, payable semiannually and reset semiannually. Entity B and Entity C enter into a netting arrangement that permits each party to offset its rights and obligations under the agreements. The netting arrangement meets the criteria for offsetting in Subtopic 210-20. The net effect of offsetting the contracts for both Entity B and Entity C is the economic equivalent of an interest rate swap arrangement, that is, one party receives a fixed interest rate from, and pays a variable interest rate to, the other.

55-180 In this Case, based on the facts presented, there is no clear business purpose for the separate transactions, and they should be accounted for as an interest rate swap under this Subtopic. However, in other instances, a clear substantive business purpose for entering into two separate loan transactions may exist (for example, as a means to overcome foreign currency expatriation restrictions).

Note that the SEC staff has indicated that it will challenge the accounting for transactions that have been structured to circumvent GAAP. EITF Issue 02-2 (not codified) states, in part:

The SEC Observer encouraged the [FASB] to examine the broader issue of when to combine transactions and noted that, in the interim, the SEC staff will continue to challenge the accounting for transactions for which it appears that multiple contracts have been used to circumvent generally accepted accounting principles.

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**3.3.2.3 Application to Debt With Detachable 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, as long as both of the following apply, 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:

- 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 equivalent to meeting condition (b) in the ASC master glossary definition of a freestanding financial instrument (see Section 3.3.2.1).

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.”

3.3.3 Other Elements That Warrant Separate Accounting Recognition

3.3.3.1 Background

25-4 . . . If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges shall be given accounting recognition . . . .

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).

In addition to any freestanding financial instruments (see Section 3.3.2), a debt issuer should consider whether a debt transaction contains any other elements that warrant accounting recognition separately from the debt. For example:

- Contractual terms that are within the scope of the guidance on registration payment arrangements in ASC 825-20 must be treated as a separate unit of account (see Section 3.3.3.2).
- When an entity elects to account for debt by applying the fair value option in ASC 815-15 or ASC 825-10, the unit of account for the debt excludes any inseparable third-party guarantee (see Section 3.3.3.3).
- If debt is issued in exchange for cash and other rights or privileges that do not form part of the debt, those other rights or privileges should be recognized separately (see Section 3.3.3.4).
- Sometimes a debt transaction involves the exchange of nonfinancial items (see Section 4.3.5).
• A debt issuer should evaluate features embedded in hybrid debt instruments to determine whether such features must be separated as derivatives under ASC 815 (see Chapter 8). (Note that the transaction proceeds are first allocated among the hybrid debt instrument and any other freestanding financial instruments before the embedded derivative is bifurcated from the hybrid debt instrument.)

• A debt issuer should evaluate convertible debt to determine whether it includes a separable equity component under the guidance in ASC 470-20 on BCFs, CCFs, and in-substance premiums (see Section 7.6). (Note that the transaction proceeds are first allocated among the convertible debt and any other freestanding financial instruments before a BCF, CCF, or in-substance premium is recognized.)

To identify transaction elements that warrant separate accounting recognition, the debt issuer must sometimes perform a more careful evaluation of the transaction and apply professional judgment (e.g., if the effective interest rate that would be computed on the basis of the initially ascribed debt proceeds is unreasonable; see Section 3.3.3.4).

3.3.3.2 Registration Payment Arrangement

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration Payment Arrangement</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>
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.

30-2 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. An issuer of a debt instrument may agree to pay specified amounts if a registration statement for the resale of the instrument or other instruments subject to the arrangement (e.g., shares that might be delivered upon conversion of the debt) is not declared effective or if effectiveness of the registration statement is not maintained. 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 or 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.
A registration payment arrangement is treated as a unit of account that is separate from the related debt instrument even if such payment arrangement is included in the terms of the debt instrument. However, a payment arrangement that does not meet the definition of a registration payment arrangement is 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 815-15 (see Section 8.4.7).

### 3.3.3.3 Debt Issued With Third-Party Guarantee

<table>
<thead>
<tr>
<th>ASC 825-10</th>
</tr>
</thead>
</table>

| 25-13 For the issuer of a liability issued with an inseparable third-party credit enhancement (for example, debt that is issued with a contractual third-party guarantee), the unit of accounting for the liability measured or disclosed at fair value does not include the third-party credit enhancement. This paragraph does not apply to the holder of the issuer’s credit-enhanced liability or to any of the following financial instruments or transactions: |
| a. A credit enhancement granted to the issuer of the liability (for example, deposit insurance provided by a government or government agency) |
| b. A credit enhancement provided between reporting entities within a consolidated or combined group (for example, between a parent and its subsidiary or between entities under common control). |

An issuer of a debt security might purchase a financial guarantee from a third party that guarantees that it will pay its debt obligation. The issuer incorporates the guarantee into the terms of the debt such that it transfers with the security in transactions among investors. By packaging the debt with a third-party guarantee, the issuer is able to reduce the debt’s stated interest rate or receive higher debt proceeds.
If third-party guaranteed debt is accounted for at fair value (e.g., under the fair value option in ASC 815-15 or ASC 825-10; see Sections 4.4 and 8.5.6), the debt’s fair value is determined as if it was not guaranteed (see ASC 820-10-35-18A and ASC 825-10-25-13). Upon debt issuance, therefore, the debt proceeds would be allocated between the debt and the third-party guarantee.

**Example 3-6**

**Debt Issued With Third-Party Guarantee**

In connection with a debt issuance, Entity A agrees to pay $2.5 million to Entity C in exchange for C’s guarantee to pay the holder of A’s debt any outstanding principal or interest payments that become due if A were to default on such payments. The guarantee is incorporated into the debt terms, and it transfers with the debt. Entity A receives $100 million of debt proceeds. Without the guarantee, the fair value of the debt is estimated to be $97.5 million. Entity A elects to apply the fair value option to the debt. It treats the payment to the guarantor for the guarantee as an up-front cost or fee, which is expensed under ASC 825-10-25-3, and the amount allocated to the guarantee from the debt proceeds as a reimbursement of its payment to the guarantor. At inception, A makes the following accounting entries:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Cash/payable to guarantor</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Debt</td>
<td>97,500,000</td>
</tr>
<tr>
<td>Expense</td>
<td>2,500,000</td>
</tr>
</tbody>
</table>

Note that in this example, the amount paid to purchase the guarantee equals the difference between the principal amount and initial fair value of the issued debt without the guarantee; if this was not the case, the issuer would recognize an inception gain or loss for the difference.

This guidance does not apply to guaranteed debt that is not accounted for or disclosed at fair value. When debt is accounted for at amortized cost, it is acceptable not to allocate any amount of the debt proceeds to the guarantee (i.e., a guarantee asset is not recognized). Nevertheless, the payment to the guarantor represents a debt issuance cost that should be deducted from the debt proceeds under ASC 825-10-25-3, and the amount allocated to the guarantee from the debt proceeds as a reimbursement of its payment to the guarantor. At inception, A makes the following accounting entries at inception:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred financing cost</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Cash/payable to guarantor</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Debt</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Debt</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Deferred financing cost</td>
<td>2,500,000</td>
</tr>
</tbody>
</table>

**3.3.3.4 Other Transaction Elements**

**ASC 835-30**

25-4 When a note is received or issued solely for cash and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged. If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges shall be given accounting recognition as described in paragraph 835-30-25-6.
A note issued solely for cash equal to its face amount is presumed to earn the stated rate of interest. However, in some cases the parties may also exchange unstated (or stated) rights or privileges, which are given accounting recognition by establishing a note discount or premium account. In such instances, the effective interest rate differs from the stated rate. For example, an entity may lend a supplier cash that is to be repaid five years hence with no stated interest. Such a non-interest-bearing loan may be partial consideration under a purchase contract for supplier products at lower than the prevailing market prices. In this circumstance, the difference between the present value of the receivable and the cash loaned to the supplier is appropriately regarded as an addition to the cost of products purchased during the contract term. The note discount shall be amortized as interest income over the five-year life of the note, as required by Section 835-30-35.

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).

If a debt transaction involves other stated or unstated rights or privileges, an issuer must recognize those rights or privileges separately from the debt by allocating or attributing an amount to them upon initial recognition of the debt. For example, ASC 835-30-25-6 specifies that if an issuer extends a three-year loan that pays no interest to a supplier in exchange for cash equal to the face amount of the loan and a right to purchase products from the supplier at a below-market price, a portion of the amount lent equal to the difference between the cash paid and the present value of the receivable must be attributed to the right and added to the cost of the products purchased during the contract term (i.e., the right is accounted for as an asset that is separate from the loan). Although that example applies to the creditor's accounting, the requirement in ASC 835-30-25-6 to separately recognize other stated or unstated rights or privileges separately from a debt instrument also applies to the debtor (see Section 4.3.4).

To appropriately identify all accounting elements that warrant separate accounting recognition, an issuer may sometimes need to more carefully examine the nature, purpose, and economic substance of a transaction and apply professional judgment. If the effective interest rate that would be computed on the basis of the debt proceeds is unreasonable (e.g., it does not reflect the general level of interest rates and the issuer's creditworthiness), the debt's initial fair value is materially different from the amount of debt proceeds received, or the accounting otherwise appears misleading, the transaction presumptively includes other elements that should be identified and recognized separately from the debt, and appropriate disclosures should be provided. Entities are strongly encouraged to consult with their independent accountants in these circumstances.

At the 2014 AICPA Conference on Current SEC and PCAOB Developments, SEC Professional Accounting Fellow Hillary Salo noted that entities need to closely evaluate a transaction in which the fair value of the financial liabilities issued exceeds the net proceeds received to determine whether (1) the fair value measurements are appropriate, (2) the transaction is with a related party, or (3) any other identifiable transaction elements exist (see Section 3.4.3.1). She indicated that if no other transaction element can be identified, the difference should be recognized as an expense. Although her remarks focused on liabilities that are accounted for at fair value on a recurring basis, they are also relevant in other situations in which the amount of proceeds initially attributed to a debt issuance (1) would result in an unreasonable effective interest rate or (2) is clearly different from the debt's fair value at issuance.
Debt transactions with related parties might include a distribution or contribution component (see Section 9.3.7 for a discussion of the accounting for debt extinguishments with related parties). In practice, a pro rata distribution to equity owners is recognized as an equity transaction (i.e., as a deemed dividend with a debt to retained earnings or other applicable equity account; see Section 9.5.5 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity), whereas a non-pro-rata distribution is recognized as a charge to earnings in the period in which the distribution is declared. Accordingly, if a debt transaction involves a payment to a related party that is not attributable to the debt, the recognition of an expense might be required upon issuance unless the payment represents a pro rata distribution to all holders of common stock or equivalent ownership interests, in which case it may be treated as an equity distribution. Paragraphs 3 and 5 of FASB Technical Bulletin (FTB) 85-6 (partially codified in ASC 505-30) contain the following analogous examples of rights or privileges for which separate accounting recognition might be required as an expense in a transaction with a related party:

Example 3-7

Debt Issued With Loan Commitment and Warrants

Entity B enters into a credit facility arrangement with a lender for the issuance of a term loan facility in the aggregate principal amount of up to $150 million. The contractual terms specify the issuance of a term loan advance of $5 million at the closing of the agreement. Additional term loan advances are available to B under the arrangement as follows:

- Six months after closing, B may request an additional term loan advance from the lender of $45 million if certain financial and operational conditions are met.
- One year after closing, B may request an additional term loan advance from the lender of $50 million if certain financial and operational conditions are met.
- Two years after closing, B may request an additional term loan advance from the lender of up to $50 million if certain financial and operational conditions are met.

The drawn and undrawn components of the debt arrangement cannot be legally detached from each other by either B or the lender (i.e., they cannot be transferred separately; see Section 3.3.2.1). At the arrangement’s inception, the lender pays $5 million in cash to B, and B gives the lender net-cash settleable warrants on its own stock that have an initial fair value of $7 million. The warrants represent freestanding financial instruments, meet the definition of a derivative in ASC 815, and do not qualify for any scope exception from derivative accounting. Accordingly, they are required to be accounted for at fair value, with changes in fair value recognized in earnings. The initial term loan advance is on market terms for a similar borrower for debt with similar terms (i.e., its fair value is $5 million) and does not meet the definition of a derivative in ASC 815. Further, the fair value of the commitments B has received from the lender to obtain additional term loan advances in the future is $7 million. The transaction is on arm’s-length terms; economically, B has received cash and loan commitments with an aggregate fair value of $12 million and has issued debt and warrants with an aggregate fair value of $12 million.

Because the drawn and undrawn components of the debt arrangement cannot be legally detached by either B or the lender, they do not represent freestanding financial instruments that are separate from each other (see Section 3.3.2.1). Further, since the undrawn component meets the scope exception for loan commitments, it does not qualify as a derivative under ASC 815-10 and would not be bifurcated and accounted for separately from the debt under ASC 815-15 (see Section 8.4.6).
**Example 3-7 (continued)**

If the rights and privileges associated with the loan commitments given by the lender were not separately recognized, the accounting would be misleading. That is, B would need to either (1) reduce the initial carrying amount of the advance to zero and recognize an up-front loss of $2 million even though B has not incurred any economic loss and has an obligation to repay the advance or (2) recognize the advance as an asset of $2 million even though it represents an obligation, since that is the net fair value of the advance and commitments. By analogy to Ms. Salo’s remarks at the 2014 AICPA Conference on Current SEC and PCAOB Developments (see Section 3.4.3.1), it would be appropriate in this example for B to recognize the loan commitments as a component of the proceeds it has received for the advance (i.e., as an asset) separately from the advance. Entity B would make the following accounting entries:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitment asset</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Debt</td>
<td></td>
</tr>
<tr>
<td>Liability-classified warrants</td>
<td>7,000,000</td>
</tr>
</tbody>
</table>

### 3.4 Allocation of Proceeds to Units of Account

#### 3.4.1 Background

This section discusses an issuer’s allocation of proceeds among freestanding financial instruments when those instruments are issued in a single transaction, including allocation methods (see Section 3.4.2 below) and certain application issues (see Section 3.4.3).

#### 3.4.2 Allocation Methods

##### 3.4.2.1 Background

Generally, an issuer uses one of the following two approaches to allocate proceeds received upon a debt issuance among freestanding financial instruments and any other elements that are part of the same transaction:

- A with-and-without method (also known as a residual method; see Section 3.4.2.2).
- A relative fair value method (see Section 3.4.2.3).

The appropriate allocation method depends on the accounting that applies to each freestanding financial instrument issued as part of the transaction (see Section 3.3.2). 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 3.3.3).

Proceeds are allocated among the freestanding financial instruments that form part of the same transaction before any amounts are allocated to component parts of those freestanding financial instruments (such as an equity component that is separately recognized under ASC 470-20 or an embedded derivative instrument that is bifurcated under ASC 815-15).

After applying the appropriate method for allocating proceeds among freestanding financial instruments, an entity would evaluate whether any of those instruments contain embedded derivatives that require separation under ASC 815-15 (see Chapter 8). If so, it would use the with-and-without method to separate them from the host contract (see Sections 3.4.2.2 and 8.5.3.1).
3.4.2.2 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; see Section 4.4), the issuer should use the with-and-without method to allocate the 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 (see Section 8.5.3.1).

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(s) 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 1” gain or loss in earnings that is not associated with a change in the fair value of the instrument(s) 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 3-8

Debt Issued With Liability-Classified Warrants

Entity C issues debt to Entity 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. Entity 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 (see Section 4.4), C will account for it at amortized cost by using the interest method in ASC 835-30 (see Section 6.2). 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 that the issuer may be required 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 Chapter 5 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity). Entity 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 (see Section 6.2).

3.4.2.3 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 uses the with-and-without method to measure freestanding financial instruments at fair value, more than one freestanding financial instrument remains. To apply the relative fair value method, the entity allocates the proceeds (or remaining proceeds after using the with-and-without method) on the basis of the fair values of each freestanding financial instrument at the time of the instrument’s issuance. ASC
470-20-25-2 requires an entity to use the relative fair value approach to allocate proceeds in certain transactions involving debt and detachable warrants (see Section 3.4.3.2). 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 the issuer needs to independently measure each freestanding financial instrument issued as part of the transaction, more fair value estimates must be made 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.

When a debt transaction involves both the issuance of financial instruments and the receipt of noncash financial assets (e.g., tranche debt financings that include the issuance of debt and the receipt of loan commitments), the fair value of the noncash financial assets received may be treated as part of the total proceeds received. Under this approach, the sum of the amount of cash proceeds and the fair value of the noncash financial assets received is allocated on a relative fair value basis to the financial instruments issued.

After using the appropriate method(s) to allocate the proceeds to the freestanding financial instruments, the entity should separate any component parts from an individual freestanding financial instrument in accordance with applicable GAAP (e.g., embedded derivatives).

### 3.4.3 Application Issues

#### 3.4.3.1 Fair Value Exceeds Debt Proceeds

Sometimes the estimated fair value as of the issuance date of the liabilities that are subsequently accounted for at fair value (e.g., debt that is accounted for under the fair value option in ASC 825-10 and detachable warrants that are accounted for as derivatives under ASC 815) exceeds the amount of net debt proceeds received.

**Example 3-9**

**Fair Value of Instruments Exceeds Proceeds Received**

Entity Y issues debt and detachable warrants for $100 million of cash proceeds. It elects to account for the debt at fair value under the fair value option under ASC 825-10. Accordingly, Y must account for the warrants as derivatives at fair value under ASC 815. The total estimated fair value of the debt and the warrants is $120 million as of the issuance date.
At the 2014 AICPA Conference on Current SEC and PCAOB Developments, SEC Professional Accounting Fellow Hillary Salo stated, in part:

The staff understands that there are substantive reasons reporting entities may enter into these types of arrangements, including circumstances in which alignment with a particular investor is viewed as beneficial to the reporting entity or because a reporting entity is in financial distress and requires financing. For example, assume 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. In this case, the fair value of the financial liability required to be measured at fair value (that is, the embedded derivative) exceeds the net proceeds received under the transaction.

Ms. Salo advised entities to apply judgment and perform the following steps in determining the appropriate accounting for “these types of unique fact patterns”:

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

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.”

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.”

In practice, pro rata distributions to equity owners are recognized as equity transactions (i.e., as a deemed dividend with a debit to retained earnings or other applicable equity account), whereas non-pro-rata distributions are recognized as a charge to earnings in the period in which the distribution is declared. Accordingly, 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.

In her speech, Ms. Salo emphasized that transactions that are not at arm’s length or are entered into with a related party “require significant judgment; therefore, [the SEC staff] would encourage consultation with OCA in those circumstances.”

Connecting the Dots
An entity must apply the fair value measurement requirements in ASC 820 when calculating estimated values. 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).
rights or privileges, or transaction costs; see Section 3.3.3). If so, those elements should be recognized separately (e.g., as an asset or expense in accordance with other applicable GAAP). Paragraph 3 of FTB 85-6 (partially codified in ASC 505-30) includes an analogous presumption that a purchase of shares at a price significantly in excess of the open market price suggests that the transaction includes other elements:

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 an entity, after performing these steps, 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). Ms. Salo indicated that the SEC staff expects “clear and robust disclosure of the nature of the transaction, including reasons why the entity entered into the transaction and the benefits received.”

### 3.4.3.2 Debt With Detachable Warrants

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-2</strong> 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.</td>
</tr>
<tr>
<td><strong>25-3</strong> 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.</td>
</tr>
<tr>
<td><strong>30-1</strong> 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.</td>
</tr>
<tr>
<td><strong>30-2</strong> 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.</td>
</tr>
</tbody>
</table>

When an entity issues debt together with detachable stock purchase warrants that represent separate freestanding financial instruments (see Section 3.3.2), 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, 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. 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.

Accordingly, the portion of the proceeds allocated to the warrants should be accounted for as paid-in capital only if the warrants qualify for classification as equity instruments. If warrants must be classified as a liability under ASC 480-10, ASC 815-40, 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 when classifying detachable warrants as liabilities or equity or when allocating proceeds between debt and detachable warrants.

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 (i.e., warrant is measured initially at fair value and debt is measured as the residual; see Section 3.4.2.2).</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 are necessary (see Section 3.4.3.1). If it is determined that the transaction price does not represent fair value, additional factors must be considered. Otherwise, a relative fair value method may be reasonable.</td>
</tr>
</tbody>
</table>

### 3.5 Allocation of Issuance Costs to Units of Account

#### 3.5.1 Background

This section discusses (1) how an issuer should allocate issuance costs among freestanding financial instruments when those instruments are issued in a single transaction (see Section 3.5.2) and (2) certain application issues (see Section 3.5.3). For a discussion of what qualifies as a debt issuance cost, see Section 5.2.
3.5.2 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 3.5.3.4). Otherwise, the allocation method is based on the specific facts and circumstances.

If the proceeds are allocated solely on the basis of the relative fair value method, the related issuance costs should also be allocated on that basis, which is consistent with the guidance in SAB Topic 2.A.6 (see Section 3.5.3.3).

If an entity allocates the proceeds by using 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 generally appropriate in the allocation of the related issuance costs:

- **The relative fair value method** — The entity allocates issuance costs on the basis of the relative fair values of the freestanding financial instruments by analogy to ASC 470-20-25-2. SAB Topic 2.A.6 (see Section 3.5.3.3) 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, the entity expenses as incurred any issuance costs allocated to the debt under the relative fair value method because presenting a debt liability as an asset would be inappropriate.

- **An approach that is consistent with the allocation of proceeds** — The entity allocates issuance costs in proportion to the allocation of proceeds between the freestanding financial instruments (see Section 3.4.2). 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 (see Section 3.5.3.4).

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, for example, ASC 825-10-25-3).

3.5.3 Application Issues

3.5.3.1 Credit Facilities With Both Revolving and Nonrevolving Components

An entity might incur costs and fees to obtain a credit facility that includes both revolving- and nonrevolving-debt components. The portion of the costs and fees that are allocated to the nonrevolving component is deferred as an asset before the issuance of debt and reduces the initial net carrying amount of any debt drawn (see Section 5.3). The portion allocated to the revolving component is treated as a cost or fee to obtain a line-of-credit or revolving-debt arrangement (see Section 5.4). If a portion of the costs and fees paid is attributable to services received that are not directly related to the debt arrangement, that portion is allocated to those services (see Section 3.5.3.3).
3.5.3.2 Transactions That Involve the Receipt of Noncash Financial Assets

When a debt issuance transaction involves the receipt of noncash financial assets by the issuing entity (e.g., tranche debt financings that include the issuance of debt and the receipt of loan commitments at inception), the related issuance costs may be allocated in one of two ways:

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

Example 3-10

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 that provides the following fair value estimates:

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

Entity S does not elect to account for the notes by using the fair value option in ASC 825-10 and has a policy of allocating issuance costs on a relative fair value basis under ASC 470-20-25-2 (see Section 3.4.2.3). Entity S can elect to use either of the following approaches to allocate the issuance costs:

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

Under this approach, the proceeds received after deduction of third-party costs are allocated 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</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>


### Example 3-10 (continued)

#### Relative Fair Value Allocation

<table>
<thead>
<tr>
<th></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></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></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>

#### Components of Fair Value Allocation — Warrants

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

#### Journal Entry — If Warrants Classified in Equity

<table>
<thead>
<tr>
<th>Account</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>773,615</td>
</tr>
<tr>
<td>Debt discount — original issuance</td>
<td>13,467,405</td>
</tr>
<tr>
<td>Commitment asset</td>
<td>38,385,821</td>
</tr>
<tr>
<td>Debt — principal amount</td>
<td>30,000,000</td>
</tr>
<tr>
<td>APIC — warrants</td>
<td>49,426,841</td>
</tr>
</tbody>
</table>

#### Journal Entry — If Warrants Classified as Liability

<table>
<thead>
<tr>
<th>Account</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>773,615</td>
</tr>
<tr>
<td>Debt discount — original issuance</td>
<td>13,467,405</td>
</tr>
<tr>
<td>Commitment asset</td>
<td>38,385,821</td>
</tr>
<tr>
<td>Expense — warrant issue costs</td>
<td>2,426,385</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>
### Example 3-10 (continued)

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

Under this approach, third-party costs are allocated 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 of the third-party costs to the loan commitment asset is also 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>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><strong>Total</strong></td>
<td><strong>$68,385,821</strong></td>
</tr>
</tbody>
</table>

#### Relative Fair Value — Absolute Amounts

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Percentage</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><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>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

- **Cash** 26,800,000
- **Debt discount — issue costs** 495,490
- **Debt discount — original issuance** 13,467,405
- **Commitment asset** 39,536,263
  - **Debt — principal amount** 30,000,000
  - **APIC — warrants** 50,299,158

#### Journal Entry — If Warrants Classified as Liability

- **Cash** 26,800,000
- **Debt discount — issue costs** 495,490
- **Debt discount — original issuance** 13,467,405
- **Commitment asset** 39,536,263
- **Expense — warrant issue costs** 1,554,068
  - **Debt — principal amount** 30,000,000
  - **Liability — warrants** 51,853,226
Example 3-10 (continued)

Note that since it would be inappropriate to allocate negative third-party costs to the loan commitment asset, an entity determines the relative fair values on the basis of the absolute amounts of the items. In this example, because the fair value of the proceeds received equals that of the financial instruments issued, the use of the relative fair value allocation method does not affect the allocation of proceeds to the financial instruments issued.

3.5.3.3 Interim Bridge Financing and Other Services

SEC Staff Accounting Bulletins


Facts: Company A is to acquire the net assets of Company B in a transaction to be accounted for as a business combination. In connection with the transaction, Company A has retained an investment banker to provide advisory services in structuring the acquisition and to provide the necessary financing. It is expected that the acquisition will be financed on an interim basis using “bridge financing” provided by the investment banker. Permanent financing will be arranged at a later date through a debt offering, which will be underwritten by the investment banker. Fees will be paid to the investment banker for the advisory services, the bridge financing and the underwriting of the permanent financing. These services may be billed separately or as a single amount.

Question 1: Should total fees paid to the investment banker for acquisition-related services and the issuance of debt securities be allocated between the services received?

Interpretive Response: Yes. Fees paid to an investment banker in connection with a business combination or asset acquisition, when the investment banker is also providing interim financing or underwriting services, must be allocated between acquisition related services and debt issue costs.

When 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, the total fees incurred by an entity should be allocated between the services received on a relative fair value basis. The objective of the allocation is to ascribe the total fees incurred to the actual services provided by the investment banker.

FASB ASC Topic 805, Business Combinations, provides guidance for the portion of the costs that represent acquisition-related services. The portion of the costs pertaining to the issuance of debt or equity securities should be accounted for in accordance with other applicable GAAP.

Question 2: May the debt issue costs of the interim “bridge financing” be amortized over the anticipated combined life of the bridge and permanent financings?

Interpretive Response: No. Debt issue costs should be amortized by the interest method over the life of the debt to which they relate. Debt issue costs related to the bridge financing should be recognized as interest cost during the estimated interim period preceding the placement of the permanent financing with any unamortized amounts charged to expense if the bridge loan is repaid prior to the expiration of the estimated period. Where the bridged financing consists of increasing rate debt, the guidance issued in FASB ASC Topic 470, Debt, should be followed.\footnote{As noted in FASB ASC paragraph 470-10-35-2, the term-extending provisions of the debt instrument should be analyzed to determine whether they constitute an embedded derivative requiring separate accounting in accordance with FASB ASC Topic 815, Derivatives and Hedging.}
SAB Topic 2.A.6 (reproduced in ASC 340-10-599-2) addresses an entity’s accounting for fees paid to an investment bank to obtain interim bridge financing and other services in connection with an acquisition that will be accounted for as a business combination. The fees paid represent consideration for multiple items received, including (1) interim bridge financing to help the entity pay for the acquisition, (2) underwriting services related to a future debt offering to finance the acquisition on a more permanent basis, and (3) acquisition-related advisory services. Under this guidance, an entity must allocate the fees paid between the different components (i.e., the bridge financing, the underwriting services, and the acquisition-related services) on a relative fair value basis.

Although the debtor may anticipate that the interim bridge financing will be replaced by permanent debt financing, the costs allocated to the interim bridge financing are amortized over the estimated life of the interim financing. Any remaining unamortized costs attributed to the interim bridge financing are charged to earnings once the bridge financing is repaid. Those costs cannot be treated as an issuance cost of the subsequent debt offering.

### 3.5.3.4 Convertible Debt Within the Scope of the CCF Guidance in ASC 470-20

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-26</strong> 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><strong>30-31</strong> 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 in ASC 470-20 (see Section 7.6.4) 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.

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.
Chapter 4 — Initial Recognition and Measurement of Debt

4.1 Background
Debt is initially recognized on the settlement date (see Section 4.2 below). There is a presumption that debt issued solely in exchange for cash should be initially recognized at the amount of cash proceeds received (see Section 4.3.4). However, an entity should evaluate debt that is issued in exchange for property, goods, or services to determine whether to initially measure it at (1) its face amount or (2) the present value of the cash flows, discounted by using an imputed interest rate (i.e., at fair value under ASC 820) (see Section 4.3.5). Any difference between the debt's initial carrying amount and stated principal amount represents a discount or premium (see Section 4.3.6). In addition, any debt for which the issuer elects the fair value option in ASC 815-15 or ASC 825-10 is initially measured at its fair value, with any up-front costs or fees incurred recognized immediately in earnings (see Section 4.4).

4.2 Recognition Date
In practice, debt liabilities are initially recognized on the settlement date (i.e., the date on which the debtor receives the related proceeds such as cash or other financial or nonfinancial assets) as opposed to the date on which the debt is priced or the parties enter into a binding agreement to issue it.

The debt's settlement date may differ from the date on which any related hedging transaction is recognized. In FASB Statement 133 Implementation Issue No. E23 (not codified), the Basis for Conclusions states, in part:

It is customary for a debtor or investor to enter into an at-market interest rate swap at the date the issuance or purchase of an interest-bearing asset or liability is firmly committed to and priced (referred to herein as the trade date), because at that date the debtor or investor begins to be exposed to changes in interest rates. The debt obligation often is not recognized for financial reporting purposes until it is issued several days later (on the settlement date). Consequently, if a hedging relationship is designated on the trade date, the hedged item may not yet be a recognized asset or liability. [Emphasis added]

If an entity enters into an agreement that requires or permits it to issue debt in the future, it should consider whether it must recognize that agreement as a derivative under ASC 815-10 until the debt is funded. Usually, such contracts are not within the scope of the accounting requirements for derivatives because ASC 815 contains a scope exception for loan commitments (see Section 2.3.3), and the contract might not meet the net settlement characteristic in the definition of a derivative (see Section 8.3.4.4). If an entity incurs costs and fees associated with a future debt issuance or a commitment that requires or permits it to issue debt in the future, it may need to capitalize such costs and fees as an asset (see Chapter 5).
4.3 Debt Subject to ASC 835-30

4.3.1 Background

ASC 835-30 provides guidance on the initial measurement of debt for which the issuer has not elected the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4). Certain types of payables are exempt from the scope of this guidance (see Section 4.3.2 below). While debt is initially measured at the present value of the debt's contractual cash flows (see Section 4.3.3), the initial measurement guidance in ASC 835-30 on debt issued in exchange for cash (see Section 4.3.4) is different from that on debt issued in exchange for property, goods, or services (see Section 4.3.5). Section 4.3.6 describes the concepts of discount and premium.

4.3.2 Scope

<table>
<thead>
<tr>
<th>ASC 835-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-3</td>
</tr>
<tr>
<td>a.</td>
</tr>
<tr>
<td>b.</td>
</tr>
<tr>
<td>c.</td>
</tr>
<tr>
<td>e.</td>
</tr>
<tr>
<td>f.</td>
</tr>
<tr>
<td>g.</td>
</tr>
<tr>
<td>h.</td>
</tr>
</tbody>
</table>

The initial measurement guidance in ASC 835-30 applies to both receivables and payables other than items (1) for which the entity has elected the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4) or (2) that meet one or more of the scope exceptions in ASC 835-30. ASC 835-30-15-3 includes the following scope exceptions:

- Payables resulting from the purchase of goods or services from suppliers in the normal course of business on customary terms not exceeding approximately one year (i.e., trade payables).
- Payables to a parent, subsidiary, or entity under common control.
- Debt that has an interest rate that is “affected by the tax attributes or legal restrictions prescribed by a governmental agency” such as “industrial revenue bonds, tax exempt obligations, government guaranteed obligations, [and] income tax settlements.”
• Certain obligations associated with sales of property, goods, or services:
  ◦ Amounts that will be applied as a reduction to the price of property, goods, or services, such as deposits, advances, and progress payments, except for amounts promised in a contract with a customer (see Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard* for a discussion of the accounting for revenue contracts with a significant financing component).
  ◦ Warranties for product performance and other obligations assumed in connection with sales of property, goods, or services.
  ◦ Contract liabilities (i.e., “an entity's obligation to transfer goods or services to a customer for which the entity has received consideration from the customer”; see Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*).

• Security deposits.

### 4.3.3 Present Value Concepts

A key concept in ASC 835-30 is that the initial measurement of debt represents the present value of the debt's principal and interest cash flows, discounted by using an appropriate interest rate. As discussed in Section 2.3.1.1 of Deloitte’s *A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option)*, when a note payable (i.e., debt) is initially recognized on the basis of a present value technique under ASC 835-30, the measurement is a fair value measurement subject to the guidance in ASC 820.

If debt is issued solely for cash and no other rights or privileges are involved, there is a presumption that present value equals the cash proceeds received (see Section 4.3.4). In this circumstance, the debtor identifies the appropriate discount rate (i.e., the debt's effective interest rate) by equating the cash proceeds received to the debt's contractual cash flows (see Section 6.2.3.2). If debt is issued in exchange for property, goods, or services, however, the stated interest rate may not be an appropriate discount rate (see Section 4.3.5.1). Consequently, if interest is imputed at an appropriate rate (i.e., the debt's contractual cash flows are discounted by using an appropriate imputed discount rate that differs from the stated interest rate), the debt is recognized at a discount or premium (see Section 4.3.6). The discount or premium represents the difference between the principal amount of the debt and the present value of the contractual cash flows, calculated by using a discount rate that is appropriate in the circumstances.

**ASC 835-30**

*Example 1: Illustration of Present Value Concepts*

55-4 This Example illustrates the guidance in paragraphs 835-30-05-2, 835-30-25-3 through 25-4, and 835-30-25-10 through 25-11 that the coupon or stated rate of interest and the face amount of a note or bond may not be the appropriate bases for valuation. The presumption that market values provide the evidence for valuation must be overcome before using coupon or stated rates and face or maturity amounts as the bases for accounting.
55-5 Upon issuance of a note or bond, the issuer customarily records as a liability the face or principal amount of the obligation. Ordinarily, the recorded liability also represents the amount that is to be repaid upon maturity of the obligation. The value recorded in the liability account, however, may be different from the proceeds received or the present value of the obligation at issuance if the market rate of interest differs from the coupon rate of interest. For example, consider the issuance of a $1,000, 20-year bond that bears interest at 10% annually. If we assume that 10% is an appropriate market rate of interest for such a bond, the proceeds at issuance will be $1,000. The bond payable would be recorded at $1,000, which represents the amount repayable at maturity and also the present value at issuance, which is equal to the proceeds. However, under similar circumstances, if the prevailing market rate were more (less) than 10%, a 20-year 10% bond with a face amount of $1,000 would usually have a value at issuance and provide cash proceeds of less (more) than $1,000. The significant point is that, upon issuance, a bond is valued at the present value of the future coupon interest payments plus the present value of the future principal payments (face amount). These two sets of future cash payments are discounted at the prevailing market rate of interest (for an equivalent security) at the date of issuance of the debt. As the 8% and 12% columns show, premium or discount arises when the prevailing market rate of interest differs from the coupon rate.

<table>
<thead>
<tr>
<th>Assume prevailing market rate of</th>
<th>10%</th>
<th>8%</th>
<th>12%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Present value of annual interest payments of $100 (the coupon rate of 10% of $1,000) for 20 years</td>
<td>$ 851</td>
<td>$ 962</td>
<td>$ 747</td>
</tr>
<tr>
<td>2. Present value of payment of the face amount of $1,000 at the end of Year 20</td>
<td>149</td>
<td>215</td>
<td>104</td>
</tr>
<tr>
<td>Present value and proceeds at date of issuance</td>
<td>$ 1,000</td>
<td>$ 1,197</td>
<td>$ 851</td>
</tr>
</tbody>
</table>

55-6 In the case of a $1,000 non-interest-bearing 20-year note, where the prevailing market rate for comparable credit risks is 10%, the following valuation should be made.

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Present value of no annual interest payments</td>
<td>$</td>
<td>—</td>
</tr>
<tr>
<td>2. Present value of payment of the face amount of $1,000 at the end of Year 20</td>
<td>149</td>
<td></td>
</tr>
<tr>
<td>Present value and proceeds at date of issuance</td>
<td>$ 149</td>
<td></td>
</tr>
</tbody>
</table>

55-7 Comparison of the two tables shows the significant impact of interest.

4.3.4 Debt Issued in Exchange For Cash

ASC 835-30

25-4 When a note is received or issued solely for cash and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged. If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges shall be given accounting recognition as described in paragraph 835-30-25-6.
A note issued solely for cash equal to its face amount is presumed to earn the stated rate of interest. However, in some cases the parties may also exchange unstated (or stated) rights or privileges, which are given accounting recognition by establishing a note discount or premium account. In such instances, the effective interest rate differs from the stated rate. For example, an entity may lend a supplier cash that is to be repaid five years hence with no stated interest. Such a non-interest-bearing loan may be partial consideration under a purchase contract for supplier products at lower than the prevailing market prices. In this circumstance, the difference between the present value of the receivable and the cash loaned to the supplier is appropriately regarded as an addition to the cost of products purchased during the contract term. The note discount shall be amortized as interest income over the five-year life of the note, as required by Section 835-30-35.

Nonauthoritative AICPA Guidance

Technical Q&As Section 5200, “Interest Expense”

.07 Imputed Interest on Note Exchanged for Cash Only

Inquiry — If an enterprise receives cash in exchange for a non-interest bearing long-term note payable with a stated amount equal to the cash received, must interest be imputed on the note in accordance with FASB ASC 835, Interest?

Reply — If there are rights or privileges other than cash attendant to the exchange, the value of such rights or privileges should be given accounting recognition pursuant to FASB ASC 835-30-25-6. If the note is issued solely for cash (that is, the cash received is equivalent to the face amount of the note) and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged.

When an entity issues debt in a cash transaction that does not include any other elements for which separate accounting recognition is required (e.g., freestanding financial instruments or other stated or unstated rights or privileges that warrant separate accounting recognition; see Section 3.3) and the entity has not elected the fair value option in ASC 815-15 (see Section 8.5.6) or in ASC 825-10 (see Section 4.4), a presumption exists that the debt should be initially measured at the amount of cash proceeds received from the holder, adjusted for debt issuance costs (see Chapter 5). Any difference between the stated principal amount and the amount of the cash proceeds received, net of debt issuance costs, is presented as a discount or premium (see Section 4.3.6).

If a debt issuance includes other freestanding financial instruments or other elements that warrant separate accounting recognition (see Section 3.3), the cash proceeds should be allocated among the debt and those other units of account as follows: first to any instrument that must be measured at fair value, with changes recognized in earnings, and then to items not accounted for at fair value. If the issuer is required to recognize as an asset any freestanding financial instrument included in the transaction, the amount attributed to that asset would be added to the amount of proceeds that is allocated among the freestanding financial instruments that represent liabilities (and any equity instruments). See Section 3.4 for additional discussion of the allocation of proceeds and issuance costs.

Factors to consider in the determination of whether a transaction includes other elements that should be recognized separately include (1) whether the effective interest rate calculated on the basis of the proceeds allocated to the debt would be unreasonable given the general level of interest rates, (2) the issuer’s creditworthiness, and (3) the debt’s initial fair value. If the transaction conveys rights or privileges unrelated to the debt, the issuer should recognize such rights or privileges separately from the debt. If the amount attributed to such rights or privileges represents an asset or expense, such amount is added to the proceeds that are allocated to the debt and any other freestanding financial liabilities or equity instruments issued. If the transaction includes terms that meet the definition of a registration
payment arrangement, the issuer should also consider whether any amount should be allocated to that arrangement. See Section 3.3.3 for additional discussion.

If the terms of a debt instrument include embedded features or other components that must be recognized separately from the debt (e.g., any bifurcated embedded derivative under ASC 815-15 or equity component under ASC 470-20), the amount attributable to such features or components is allocated from the amount of proceeds allocated to the debt after allocation to any other freestanding financial instruments.

4.3.5 Debt Issued in Exchange for Property, Goods, or Services

4.3.5.1 General

<table>
<thead>
<tr>
<th>ASC 835-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>05-2</td>
</tr>
<tr>
<td>25-7</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>25-8</td>
</tr>
</tbody>
</table>

When an entity issues debt in exchange for property, goods, or services in a bargained transaction entered into at arm's length (i.e., the debtor is the purchaser of property, goods, or services), and there are no other separate elements in the transaction, there is a general presumption that the debt's stated rate of interest represents fair and adequate compensation for the debtor's use of the funds. In such cases, the debt is initially measured at the present value of the contractual cash flows, discounted by using the stated interest rate (i.e., typically the stated principal amount) and adjusted for debt issuance costs (see Chapter 5), unless the issuer elects the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4).

This presumption does not apply if (1) the debt has no stated interest; (2) the stated interest rate is unreasonable (e.g., it does not reflect the general level of interest rates or the issuer's creditworthiness); (3) the debt's stated amount is materially different from the current cash sales price for the same or similar items of property, goods, or services; or (4) the debt's stated amount is materially different from the debt's fair value on the date of the transaction. If the presumption is inapplicable, the issuer must use other methods to determine the debt's initial measurement (see Section 4.3.5.2).
If the terms of a debt instrument include embedded features or components that must be recognized separately from the debt (e.g., any bifurcated embedded derivative under ASC 815-15 or equity component under ASC 470-20), the amount attributed to such features or components is allocated out of the initial measurement amount.

### 4.3.5.2 Circumstances in Which the Presumption Does Not Apply

**ASC 835-30**

**05-3** This Subtopic provides guidance for the appropriate accounting when the face amount of a note does not reasonably represent the present value of the consideration given or received in the exchange. This circumstance may arise if the note is non-interest-bearing or has a stated interest rate that is different from the rate of interest appropriate for the debt at the date of the transaction. Unless the note is recorded at its present value in this circumstance, the sales price and profit to a seller in the year of the transaction and the purchase price and cost to the buyer are misstated, and interest income and interest expense in subsequent periods are also misstated.

**25-2** If determinable, the established exchange price (which, presumably, is the same as the price for a cash sale) of property, goods, or service acquired or sold in consideration for a note may be used to establish the present value of the note. When notes are traded in an open market, the market rate of interest and quoted prices of the notes provide the evidence of the present value. These methods are preferable means of establishing the present value of the note.

**25-10** In circumstances where interest is not stated, the stated amount is unreasonable, or the stated face amount of the note is materially different from the current cash sales price for the same or similar items or from the fair value of the note at the date of the transaction, the note, the sales price, and the cost of the property, goods, or service exchanged for the note shall be recorded at the fair value of the property, goods, or service or at an amount that reasonably approximates the fair value of the note, whichever is the more clearly determinable. That amount may or may not be the same as its face amount, and any resulting discount or premium shall be accounted for as an element of interest over the life of the note.

If the stated rate of interest on debt issued in exchange for property, goods, or services does not represent fair and adequate compensation for the debtor’s use of funds, the issuer should determine whether price information is available for the property, goods, services, or debt. Such information would include current cash sales prices for the same or similar items of property, goods, or services or, if the debt is traded in an open market, the debt’s quoted price or market rate of interest. Paragraph 28 of FASB Concepts Statement 7 states, in part:

> In the absence of a cash transaction, accountants turn to other techniques for the initial measurement of an asset or liability, but the measurement objective remains the same. The process begins by determining whether others have bought or sold the same or similar items in recent cash transactions.

If price information exists, the debt is initially measured at whichever amount more clearly represents the fair value of the property, goods, services, or debt. Any difference between the stated principal amount and the initial measurement amount is presented as a discount or premium (see Section 4.3.6). If there is no price information, the debt is initially measured at the present value of its principal and interest payments, discounted by using an imputed interest rate (see Section 4.3.5.3).
4.3.5.3 **Imputed Interest Rate**

**ASC Master Glossary**

**Imputed Interest Rate**
The interest rate that results from a process of approximation (or imputation) required when the present value of a note must be estimated because an established exchange price is not determinable and the note has no ready market.

**ASC 835-30**

**10-1** The objective of the guidance in this Subtopic is to approximate the rate for a note that would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase that bears the prevailing rate of interest to maturity.

**25-3** If an established exchange price is not determinable and if the note has no ready market, the problem of determining present value is more difficult. To estimate the present value of a note under such circumstances, an applicable interest rate is approximated that may differ from the stated or coupon rate. This process of approximation is called imputation, and the resulting rate is called an imputed interest rate. Nonrecognition of an apparently small difference between the stated rate of interest and the applicable current rate may have a material effect on the financial statements if the face amount of the note is large and its term is relatively long.

**25-11** In the absence of established exchange prices for the related property, goods, or service or evidence of the fair value of the note (as described in paragraph 835-30-25-2), the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable shall be determined by discounting all future payments on the notes using an imputed rate of interest. This determination shall be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates shall be ignored.

**25-12** Paragraph 835-30-10-1 identifies the objective of the guidance in this Subtopic for approximating an interest rate. The variety of transactions encountered precludes any specific interest rate from being applicable in all circumstances. However, this paragraph provides the following general guidelines:

- a. The choice of a rate may be affected by the credit standing of the issuer, restrictive covenants, the collateral, payment and other terms pertaining to the debt, and, if appropriate, the tax consequences to the buyer and seller.
- b. The prevailing rates for similar instruments of issuers with similar credit ratings will normally help determine the appropriate interest rate for determining the present value of a specific note at its date of issuance.
- c. In any event, the rate used for valuation purposes shall be the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction.

**25-13** The selection of a rate may be affected by many considerations. For instance, where applicable, the choice of a rate may be influenced by the following:

- a. An approximation of the prevailing market rates for the source of credit that would provide a market for sale or assignment of the note
- b. The prime or higher rate for notes that are discounted with banks, giving due weight to the credit standing of the maker
- c. Published market rates for similar-quality bonds
- d. Current rates for debentures with substantially identical terms and risks that are traded in open markets
- e. The current rate charged by investors for first or second mortgage loans on similar property.
In determining the initial measurement of debt, an entity uses an imputed interest rate if all of the following conditions are met:

- The debt was issued in exchange for property, goods, or services and does not represent a trade payable or other obligation that is exempt from ASC 835-30 (see Section 4.3.2).
- Any of the following apply: (1) the debt has no stated interest; (2) the stated interest rate is unreasonable (e.g., it does not reflect the general level of interest rates or the issuer's creditworthiness); (3) the debt's stated amount is materially different from the current cash sales price for the same or similar items of property, goods, or services; or (4) the debt's stated amount is materially different from the debt's fair value on the date of the transaction.
- There are no established exchange prices for the property, goods, or services.
- The debt is not quoted in the open market.

The imputed rate represents an estimate of the interest rate at which the issuer could obtain financing of a similar nature from other sources. In other words, it is the rate that an independent borrower and lender would negotiate on the issuance date in a cash transaction under comparable terms and conditions.

Although ASC 835-30 does not explicitly describe how an entity uses an imputed rate to determine the debt's present value as a fair value measurement, the FASB has affirmed that the fair value measurement guidance in ASC 820-10 related to the application of present value techniques applies to such measurements. Paragraphs C19 and C20 of the Basis for Conclusions of FASB Statement 157 state, in part:

"[T]he Board affirmed that the measurement for receivables and payables in [ASC 835-30] determined using a present value technique, is a fair value measurement. The discount rate for contractual (promised) cash flows described in [ASC 835-30] (rate commensurate with the risk) embodies the same notion as the discount rate used in the traditional approach (or discount rate adjustment technique) described in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, and clarified in [ASC 820-10]. . . . Accordingly, the guidance for using present value techniques to measure fair value in [ASC 820-10] applies for the measurements required under [ASC 835-30]."

In estimating the imputed rate, the issuer would consider information about observed rates of interest for comparable debt as of the transaction date. Whether debt for which observable data is available can be compared depends on the debt's characteristics such as the amount and timing of the contractual cash flows, the issuer's creditworthiness (e.g., published credit rating), the seniority or subordination of the debt, collateral and other credit enhancements, restrictive covenants, tax treatment for the issuer and the holder, and any embedded features (e.g., put or call options).

If there is no debt instrument with substantially the same characteristics as the debt, the issuer might determine the imputed rate by using a build-up method that takes into account observable data related to the risk-free yield curve and credit spreads for similar debt, adjusted as appropriate for differences in the debt's characteristics. In a manner similar to the objective of a fair value measurement, the issuer should maximize the use of observable inputs (e.g., quoted prices or rates in active markets for similar debt and inputs that are derived principally or corroborated by observable market data) and minimize the use of unobservable inputs.

Guidance in ASC 820-10 that may be relevant in determining the present value of debt by using an imputed rate includes the requirements related to discount rate adjustment techniques in ASC 820-10-55-10 through 55-12, the build-up method in ASC 820-10-55-33 and 55-34, the effect of an entity's credit standing in ASC 820-10-55-57 and 55-57A, and the application of present value techniques to debt obligations in ASC 820-10-55-85 through 55-89. For additional discussion of the application of fair
value measurement techniques, see Deloitte’s *A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option)*.

Once the imputed rate has been determined, the issuer discounts the debt’s contractual cash flows by using that rate and recognizes the debt at its present value. Any difference between the debt’s present value and stated amount is presented as a discount or premium (see Section 4.3.6 below).

### 4.3.6 Discounts and Premiums

<table>
<thead>
<tr>
<th>ASC 835-30 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Discount</strong></td>
</tr>
<tr>
<td>The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity. See Premium.</td>
</tr>
<tr>
<td><strong>Premium</strong></td>
</tr>
<tr>
<td>The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity. See Discount.</td>
</tr>
</tbody>
</table>

---

**Example 4-1**

**Issuance of Debt at a Discount**

Entity D issues long-term debt with a principal amount of $100 million at a 2 percent discount to par for cash proceeds of $98 million. It makes the following entries:

| Cash                                      | 98,000,000 |
| Long-term debt (discount)                | 2,000,000  |
| Long-term debt (principal amount)        | 100,000,000|
Conceptually, premiums and discounts are valuation accounts that do not exist separately from the related debt (i.e., they are not separate units of account). Therefore, an entity is not permitted to present premiums and discounts as assets or liabilities that are separate from the debt. Instead, debt discounts are treated as deductions from, and debt premiums are treated as additions to, the carrying amount of the debt to which they are related.

Economically, reasons for the existence of a discount or premium may include the following:

- The debt’s stated interest rate differs from the market rate of interest for the instrument upon issuance. For example, if debt with a coupon rate of 6 percent is issued when the market rate of interest for similar debt is 5 percent, issuance of the debt at a premium to par would be expected since investors would be willing to invest an amount in excess of the principal amount to compensate for the above-market coupon rate. Conversely, if the market rate of interest exceeds the stated coupon rate upon issuance, issuance of the debt at a discount to par would be expected.

- The debt is a zero-coupon instrument that pays no interest during its life. Zero-coupon instruments are issued at a discount to par; the discount represents compensation for the time value of money over the debt’s life.

- The debt was issued with other freestanding financial instruments. For instance, ASC 470-20 requires the proceeds received for debt issued with detachable warrants (see Section 3.4.3.2) to be allocated between the debt and the warrants, resulting in a discount on the debt even if the transaction proceeds were equal to the principal amount of the debt.

- The debt contains an embedded component that must be separated, such as an embedded derivative under ASC 815-15 (e.g., a bifurcated put, call, or conversion feature; see Chapter 8) or an equity component under ASC 470-20 (e.g., a BCF or CCF; see Section 7.6). For example, if debt was issued at par and contains an embedded redemption feature that must be bifurcated as a derivative liability under ASC 815-15, a debt discount would arise for accounting purposes.

- The debt contains an embedded feature that is not accounted for separately from the debt. For instance, if the stated interest rate equals the market rate of interest for nonconvertible debt, but the debt contains a conversion feature that is not required to be accounted for separately from the debt, an investor should be willing to purchase the debt at a premium to par.

- The debtor paid a fee to the creditor as part of the debt issuance.

- The debt is designated as a hedged item in a fair value hedging relationship under ASC 815-25, and the carrying amount has been adjusted for changes in fair value as a result of the application of fair value hedge accounting (see Section 14.2.1.2).

If the stated interest rate on a debt instrument is fixed at different levels during the life of the debt or includes an interest-free period, a discount or premium to the principal amount could arise after the initial recognition of the debt even if the debt was issued at par. For example, if a debt instrument has an increasing interest rate (or an initial interest-free period), the application of the interest method (see Chapter 6) by using a constant effective interest rate would be expected to result in the creation of a premium during the term of the debt.
4.4 Debt Subject to the Fair Value Option

4.4.1 Background

ASC 825-10

<table>
<thead>
<tr>
<th>05-5</th>
<th>The Fair Value Option Subsections of this Subtopic address both of the following:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Circumstances in which entities may choose, at specified election dates, to measure</td>
</tr>
<tr>
<td></td>
<td>eligible items at fair value (the fair value option)</td>
</tr>
<tr>
<td>b.</td>
<td>Presentation and disclosure requirements designed to facilitate comparisons between</td>
</tr>
<tr>
<td></td>
<td>entities that choose different measurement attributes for similar types of assets and</td>
</tr>
<tr>
<td></td>
<td>liabilities.</td>
</tr>
</tbody>
</table>

Under ASC 825-10, entities can elect the fair value option to account for certain financial assets and financial liabilities at fair value. For a comprehensive discussion of this guidance, see Chapter 12 of Deloitte’s A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option). The sections below summarize the fair value option requirements that apply to items within the scope of this Roadmap.

4.4.2 Scope

ASC 825-10

<table>
<thead>
<tr>
<th>15-4</th>
<th>All entities may elect the fair value option for any of the following eligible items:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>A recognized financial asset and financial liability, except any listed in the following paragraph</td>
</tr>
<tr>
<td>b.</td>
<td>A firm commitment that would otherwise not be recognized at inception and that involves only financial instruments (for example, a forward purchase contract for a loan that is not readily convertible to cash — that commitment involves only financial instruments — a loan and cash — and would not otherwise be recognized because it is not a derivative instrument)</td>
</tr>
<tr>
<td>c.</td>
<td>A written loan commitment . . . .</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>15-5</th>
<th>No entity may elect the fair value option for any of the following financial assets and financial liabilities: . . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>e.</td>
<td>Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions.</td>
</tr>
<tr>
<td>f.</td>
<td>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).</td>
</tr>
</tbody>
</table>

An entity may elect the fair value option for any eligible item within the scope of ASC 825-10. Unless a specific scope exception applies, debt represents an eligible item for which the issuer may elect the fair value option. Under ASC 825-10-15-4(b), the fair value option is available solely to holders of an unrecognized loan commitment that (1) meets the definition of a firm commitment (e.g., the terms include a disincentive for nonperformance that is sufficiently large to make performance probable) and (2) involves only financial instruments (see Section 2.3.4).

The ability to elect the fair value option does not depend on whether (1) its application serves to mitigate volatility in reported earnings that would otherwise arise as a result of measuring items on different bases or (2) the entity manages and monitors performance of an item on a fair value basis. The ability to elect the fair value option for a debt instrument is also not predicated on the reliability of the fair value measurement; however, the inputs used for such measurement must reflect market participant assumptions (including adjustments that market participants demand for the risk associated
with unobservable inputs or the valuation technique used to determine fair value). In addition, entities are required to disclose the categorization of fair value measurements within the fair value hierarchy, including whether significant inputs to those measurements are observable or unobservable.

The fair value option is not available for financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders’ equity (including temporary equity). Thus, the fair value option cannot be elected for convertible debt for which the issuer has recognized an equity component on the debt as of an election date (see Section 7.6). An entity also cannot elect the fair value option for deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions. Instead, such liabilities are accounted for under ASC 942-405.

### 4.4.3 Election Dates

<table>
<thead>
<tr>
<th>ASC 825-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-1</strong> This Subtopic permits all entities to choose, at specified election dates, to measure eligible items at fair value (the fair value option).</td>
</tr>
<tr>
<td><strong>25-2</strong> The decision about whether to elect the fair value option:</td>
</tr>
<tr>
<td>a. Shall be applied instrument by instrument, except as discussed in paragraph 825-10-25-7</td>
</tr>
<tr>
<td>b. Shall be irrevocable (unless a new election date occurs, as discussed in paragraph 825-10-25-4)</td>
</tr>
<tr>
<td>c. Shall be applied only to an entire instrument and not to only specified risks, specific cash flows, or portions of that instrument.</td>
</tr>
<tr>
<td>An entity may decide whether to elect the fair value option for each eligible item on its election date. Alternatively, an entity may elect the fair value option according to a preexisting policy for specified types of eligible items.</td>
</tr>
<tr>
<td><strong>25-4</strong> An entity may choose to elect the fair value option for an eligible item only on the date that one of the following occurs:</td>
</tr>
<tr>
<td>a. The entity first recognizes the eligible item.</td>
</tr>
<tr>
<td>b. The entity enters into an eligible firm commitment. . . .</td>
</tr>
<tr>
<td>e. An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that . . . .</td>
</tr>
<tr>
<td><strong>25-5</strong> Some of the events that require remeasurement of eligible items at fair value, initial recognition of eligible items, or both, and thereby create an election date for the fair value option as discussed in paragraph 825-10-25-4(e) are:</td>
</tr>
<tr>
<td>a. Business combinations, as defined in Subtopic 805-10</td>
</tr>
<tr>
<td>b. Consolidation or deconsolidation of a subsidiary or VIE</td>
</tr>
<tr>
<td>c. Significant modifications of debt, as defined in Subtopic 470-50.</td>
</tr>
</tbody>
</table>

An issuer is permitted to elect the fair value option for a debt instrument on the date on which (1) the debt is first recognized, or (2) an event occurs that causes the debt to be remeasured at fair value under GAAP at the time of the event but does not result in a requirement to apply subsequent fair value measurement (e.g., a business combination). Once an entity elects the fair value option, it may not revoke fair value accounting unless a new election date occurs.

The determination of whether a debt modification or exchange qualifies as a remeasurement event for the borrower depends on whether the debt is treated as a new debt instrument under ASC 470-50 (see Section 10.4.2). If modification accounting is applied, the debt is considered to reflect the continuation
of the original contract and a new election date is not available. If extinguishment accounting applies, the new debt instrument is eligible to be elected under the fair value option at its initial recognition. If a debt modification or exchange represents a TDR (see Chapter 11), the debt instrument is not considered a new instrument and, therefore, a new election date for the fair value option is not available. For additional discussion of election dates, see Section 12.3.2 of Deloitte's A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option).

While ASC 825 provides little guidance on the documentation an entity must maintain to support its election of the fair value option, it indicates that the decision to elect the fair value option should be made as of the election date for each eligible item. Entities also have the flexibility to establish an automatic election policy for certain eligible items of an identical or similar nature. In deciding to permit entities to elect the fair value option, the FASB noted that maintaining evidence of compliance with the election requirements of ASC 825 is a matter of internal control. In all scenarios, an entity must support its fair value option election under ASC 825 with appropriate concurrent documentation that eliminates any question regarding whether the entity elected to apply fair value measurement to a particular instrument.

### 4.4.4 Level of Aggregation

**ASC 825-10**

**25-7** The fair value option may be elected for a single eligible item without electing it for other identical items with the following four exceptions:

a. If multiple advances are made to one borrower pursuant to a single contract (such as a line of credit or a construction loan) and the individual advances lose their identity and become part of a larger loan balance, the fair value option shall be applied only to the larger balance and not to each advance individually. . . .

**25-10** The fair value option need not be applied to all instruments issued or acquired in a single transaction (except as required by paragraph 825-10-25-7(a) through (b)). For example, investors in shares of stock and registered bonds might apply the fair value option to only some of the shares or bonds issued or acquired in a single transaction. For this purpose, an individual bond is considered to be the minimum denomination of that debt security.

**25-11** A financial instrument that is legally a single contract may not be separated into parts for purposes of applying the fair value option. In contrast, a loan syndication arrangement may result in multiple loans to the same borrower by different lenders. Each of those loans is a separate instrument, and the fair value option may be elected for some of those loans but not others.

Generally, an entity can elect the fair value option on an instrument-by-instrument basis. Thus, an entity can elect it for a debt instrument without doing so for other separate but identical debt instruments if they represent separate units of account (see Section 3.3). Further, ASC 825-10-25-10 specifies that an entity might elect the fair value option for only some of the bonds issued in a single transaction and that, “[f]or this purpose, an individual bond is considered to be the minimum denomination of that debt security.”

If a group of lenders jointly fund a loan to a single borrower and each lender loans a specific amount to the borrower and has the right to demand repayment from the borrower, the loan from each lender is considered separate and distinct from the loans from other lenders even if each of the loans forms part of the same overall loan syndication agreement (see Section 10.3.2.4). Thus, ASC 825-10-25-11 permits election of the fair value option for each loan in a loan syndication arrangement in which the loans are made to the same borrower by different lenders.
However, under ASC 825-10-25-11, a “financial instrument that is legally a single contract may not be separated into parts for purposes of applying the fair value option.” For example, a debt host contract that remains after the separation of an embedded financial derivative under ASC 815-15 (e.g., convertible debt with a bifurcated conversion feature) is not eligible for the fair value option. Nevertheless, the entire hybrid financial instrument is eligible for the fair value option provided that no specific exception applies to the instrument.

**Example 4-2**

**Unit of Account for Fair Value Option Election Purposes — Debt**

Entity E enters into, and documents in the same contract, a debt instrument with a $1 million principal amount and a warrant on 100,000 shares of common stock with a single investor. Since the warrant is legally detachable and separately exercisable, the debt instrument and warrant individually represent freestanding financial instruments (i.e., the debt instrument is considered an individual contract under ASC 825-10-25-11). Accordingly, E could apply the fair value option to its liability related to the $1 million debt instrument provided that it is not subject to any of the fair value option exceptions in ASC 825-10-15-5. The warrant would be separately evaluated as a liability or equity instrument under other applicable U.S. GAAP (e.g., ASC 480, ASC 815, and ASC 815-40).

However, E could not apply the fair value option to only $500,000 of the $1 million principal amount of debt because the entire principal amount represents a single unit of account and ASC 825-10-25-11 prohibits the election of the fair value option for only a portion of the amount of an individual bond. If, however, E had entered into the contract with 10 different investors, it could individually make the fair value option election for the $1 million principal amount of the debt component of each of the 10 different contracts (e.g., it could elect the fair value option for the $1 million debt component related to five investors and not elect the fair value option for the $1 million debt component for the other five investors).

An entity that can make multiple debt draws under a single credit facility (e.g., a line of credit or tranche debt financing) cannot apply the fair value option to each draw individually if, as described in ASC 825-10-25-7(a), such draws “lose their identity and become part of a larger loan balance.”

**Example 4-3**

**Unit of Account for Fair Value Option Election Purposes — Line of Credit**

Entity F has a $5 million line-of-credit agreement with Bank A. On March 1, 20X7, F draws $500,000 on its line of credit and chooses not to elect the fair value option. On April 1, 20X7, F draws another $1 million. Because the $1 million is added to the $500,000 and becomes part of the larger balance, the fair value option may not be elected for the $1 million. When F chose not to elect the fair value option for the $500,000, it also chose not to elect the fair value option for any subsequent draws on that line of credit. Under ASC 825-10-25-4, that election is irrevocable unless a new election date occurs.

An entity cannot separately elect the fair value option for the accrued interest on a debt instrument, nor can it elect the fair value option and exclude the accrued interest component. (Accrued interest simply represents one or more future interest cash flows of the debt.) Rather, in accordance with ASC 825-10-25-2(c), the entity must either (1) elect the fair value option for an interest-bearing financial asset or financial liability that includes any accrued interest or (2) not elect the fair value option for any component of an interest-bearing financial asset or financial liability.

**Section 3.3.3.3** discusses the unit of account for a liability issued with an inseparable third-party credit enhancement.
4.4.5 Initial Measurement

ASC 820-10

30-1 The fair value measurement framework, which applies at both initial and subsequent measurement if fair value is required or permitted by other Topics, is discussed primarily in Section 820-10-35. This Section sets out additional guidance specific to applying the framework at initial measurement.

30-2 When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability (an exit price). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

30-3 In many cases, the transaction price will equal the fair value (for example, that might be the case when on the transaction date the transaction to buy an asset takes place in the market in which the asset would be sold). . . .

30-3A When determining whether fair value at initial recognition equals the transaction price, a reporting entity shall take into account factors specific to the transaction and to the asset or liability. For example, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

a. The transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms.

b. The transaction takes place under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

c. The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value. For example, that might be the case if the asset or liability measured at fair value is only one of the elements in the transaction (for example, in a business combination), the transaction includes unstated rights and privileges that are measured separately, in accordance with another Topic, or the transaction price includes transaction costs.

d. The market in which the transaction takes place is different from the principal market (or most advantageous market). For example, those markets might be different if the reporting entity is a dealer that enters into transactions with customers in the retail market, but the principal (or most advantageous) market for the exit transaction is with other dealers in the dealer market.

30-6 If another Topic requires or permits a reporting entity to measure an asset or a liability initially at fair value and the transaction price differs from fair value, the reporting entity shall recognize the resulting gain or loss in earnings unless that Topic specifies otherwise.

35-3 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.

When an entity elects to measure debt (or another eligible item) under the fair value option, it initially measures it at fair value in accordance with ASC 820-10. That guidance stipulates that the fair value represents an exit price under the assumption that an asset is sold or a liability or equity instrument is transferred (assumed) in an orderly transaction between unrelated market participants under current market conditions. In many cases, the transaction price for an asset, liability, or equity instrument equals its fair value upon initial recognition. However, in certain situations, it is not appropriate to assume that the transaction price (which is an entry price) is the initial fair value (which is an exit price) of an asset, liability, or equity instrument.
Accordingly, if an issuer elects to measure debt at fair value, it needs to assess whether the debt proceeds represent the fair value at inception and consider whether one or more of the factors in ASC 820-10-30-3A are present. **Section 3.3** addresses situations in which the unit of account for the transaction price of debt differs from the unit of account for fair value accounting purposes.

In many cases, it is inappropriate to record an inception gain or loss as of the date of initial recognition. At the 2006 AICPA Conference on Current SEC and PCAOB Developments, SEC Professional Accounting Fellow Joseph McGrath stated the following:

> [W]e have heard that some believe that it is “open season” on inception gains. I would caution those constituents that there continue to be many instances in which day one gains are not appropriate. [ASC 820] does not allow the practice of “marking to model” when the transaction occurs in the entity’s principal market. Rather, transaction prices would generally be used in such a circumstance, and the model would be calibrated to match transaction price.

Mr. McGrath’s remarks indicate that if none of the factors in ASC 820-10-30-3A are present, the transaction price is most likely the best estimate of fair value. However, if any of the criteria in ASC 820-10-30-3A are met, there may be a difference between the transaction price and fair value. For example, ASC 820-10-30-3A(c) indicates that the transaction price might not represent fair value at initial recognition if “the transaction price includes transaction costs.” That might be the case in a transaction that includes a structuring fee.

For a discussion of the evaluation of situations in which the fair value exceeds the debt proceeds received, see **Section 3.4.3.1**.
Chapter 5 — Accounting for Debt Issuance Costs and Fees

5.1 Background
Entities generally incur costs and fees related to the issuance of debt. Further, an entity might incur fees and costs to secure a commitment to obtain debt financing in the future. This chapter discusses the accounting for such costs and fees.

5.2 Qualifying Debt Issuance Costs

SEC Staff Accounting Bulletins

Facts: Prior to the effective date of an offering of equity securities, Company Y incurs certain expenses related to the offering.

Question: Should such costs be deferred?

Interpretive Response: Specific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering. However, management salaries or other general and administrative expenses may not be allocated as costs of the offering and deferred costs of an aborted offering may not be deferred and charged against proceeds of a subsequent offering. A short postponement (up to 90 days) does not represent an aborted offering.

Nonauthoritative AICPA Guidance

Technical Q&As Section 4110, “Issuance of Capital Stock”

.01 Expenses Incurred in Public Sale of Capital Stock

Inquiry — A closely held corporation is issuing stock for the first time to the public.

How would costs, such as legal and accounting fees, incurred as a result of this issue, be handled in the accounting records?

Reply — Direct costs of obtaining capital by issuing stock should be deducted from the related proceeds, and the net amount recorded as contributed stockholders’ equity. Assuming no legal prohibitions, issue costs should be deducted from capital stock or capital in excess of par or stated value.

Such costs should be limited to the direct cost of issuing the security. Thus, there should be no allocation of officers’ salaries, and care should be taken that legal and accounting fees do not include any fees that would have been incurred in the absence of such issuance.

Debt issuance costs are specific incremental costs and fees that are (1) paid to third parties and (2) directly attributable to the issuance of a debt instrument. They exclude costs and fees paid to the creditor, which represent a reduction of the debt proceeds (see Section 5.3.3.2). Costs and fees that would have been incurred irrespective of whether there is a proposed or actual offering do not qualify...
as debt issuance costs. Thus, debt issuance costs represent costs and fees 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.

SAB Topic 5.A (reproduced in ASC 340-10-S99-1) addresses the accounting for expenses related to an offering of equity securities and is applicable by analogy to debt issuance costs. Under this guidance, allocated management salaries and other general and administrative expenses do not represent issuance costs. Further, if a proposed offering is aborted (including the postponement of an offering for more than 90 days), the associated costs do not represent issuance costs of a subsequent offering.

AICPA Technical Q&As Section 4110.01 addresses the accounting for expenses incurred in a public sale of capital stock and is applicable by analogy to debt issuance costs. Under this guidance, issuance costs are limited to the direct costs of issuing the security. Legal and accounting fees that would have been incurred irrespective of whether the instrument was issued do not represent issuance costs of that instrument.

The table below lists examples of costs and fees that may or may not qualify as debt issuance costs.

<table>
<thead>
<tr>
<th>Qualifying Costs if Directly Attributable to Debt Issuance¹</th>
<th>Nonqualifying Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Document preparation costs</td>
<td>• Allocated management salaries</td>
</tr>
<tr>
<td>• Costs and fees paid to attorneys, accountants, financial advisers, or other professional advisers involved in the debt issuance</td>
<td>• Allocated general and administrative expenses</td>
</tr>
<tr>
<td>• Registration costs and fees</td>
<td>• Costs and fees paid to attorneys, accountants, financial advisers, or other professional advisers if they would have been incurred irrespective of whether the instrument was issued</td>
</tr>
<tr>
<td>• Listing costs and fees</td>
<td>• Office rent</td>
</tr>
<tr>
<td>• Legal costs and fees</td>
<td>• Insurance premiums</td>
</tr>
<tr>
<td>• Underwriting costs and fees</td>
<td>• Employee bonuses</td>
</tr>
<tr>
<td>• Printing costs</td>
<td>• Employee stock option costs</td>
</tr>
<tr>
<td>• Original issue taxes</td>
<td>• Costs of an aborted offering</td>
</tr>
<tr>
<td>• Travel costs</td>
<td></td>
</tr>
<tr>
<td>• Roadshow costs</td>
<td></td>
</tr>
<tr>
<td>• Costs of third-party credit enhancements obtained for the benefit of the creditor (e.g., guarantees)</td>
<td></td>
</tr>
</tbody>
</table>

5.3 Costs and Fees Associated With Nonrevolving Debt

5.3.1 Background

Before nonrevolving debt is issued, qualifying costs and fees associated with the contemplated issuance are deferred as an asset (see Section 5.3.2), including any loan commitment fees paid to the creditor (see Section 5.3.3). Upon the debt's issuance, the costs to issue it are presented as a deduction from the debt's net carrying amount in a manner similar to a debt discount (see Section 4.3.6). Fees paid to the creditor are treated as a reduction of the debt proceeds received, not as a debt issuance cost (see Section 5.3.3.2). Debt issuance costs associated with nonrevolving debt are amortized to interest expense over the life of the related debt in a manner similar to a debt discount (see Chapter 6).

¹ Note that such costs may qualify as debt issuance costs only if they are incurred before the debt is issued. If costs incurred after an issuance of debt were not obligations as of the issue date, they cannot qualify as debt issuance costs.
The guidance in this section does not apply to debt for which the issuer has elected the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 5.5). If a transaction involves multiple units of account, the issuer should allocate the related issuance costs among those units of account (see Section 3.5). Special guidance on the allocation of transaction costs applies to convertible debt within the scope of the CCF guidance in ASC 470-20 (see Section 6.3.4 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt).

5.3.2 Accounting for Costs and Fees Incurred Before Debt Issuance

5.3.2.1 General

Entities often incur fees and costs in connection with a debt issuance before the recognition of the debt liability (e.g., document preparation costs, legal fees, and commitment fees). ASC 835-30 does not address the balance sheet presentation of such fees and costs. Further, in developing ASU 2015-03, the FASB considered but ultimately decided against providing guidance on the accounting for costs incurred before the receipt of debt proceeds. Paragraph BC4 of ASU 2015-03 states, in part:

The Board acknowledges that costs may be incurred before an associated debt liability is recorded in the financial statements (for example, the costs are incurred before the proceeds are received on a debt liability or costs incurred in association with undrawn line of credit). However, the Board did not consider providing explicit guidance in circumstances in which the proceeds have not yet been received because it observed that in practice entities defer issuance costs and apply them against the proceeds when they are received. For example, the accounting treatment for issuance costs associated with equity instruments is that the costs generally are deferred and charged against the gross proceeds of the offering (paragraph 340-10-S99-1).

Entities should present specific incremental costs and fees that are directly attributable to a contemplated issuance of debt as a deferred charge (i.e., an asset) before the issuance of the debt. This treatment applies to eligible costs and fees paid to the creditor and third parties even though amounts paid to the creditor ultimately represent a reduction of proceeds as opposed to debt issuance costs. It would be inappropriate to record a contra-liability when there is no associated liability. On the date on which the issued debt is recognized as a liability, the carrying amount of the deferred charge is reclassified as a reduction of the initial carrying amount of the debt unless those costs and fees are attributable to a line-of-credit or revolving-debt arrangement (see Section 5.4). Costs and fees paid to third parties are treated as debt issuance costs (see Section 5.3.3.1), whereas costs and fees paid to the creditor are treated as a direct deduction from the proceeds (see Section 5.3.3.2).

If an entity incurs fees and costs in connection with a contemplated debt issuance and it becomes probable that the debt will not be issued, the entity should immediately expense any related costs and fees, including any previously deferred costs, in a manner consistent with the guidance on loss contingences in ASC 450-20-25-2 (see Deloitte’s A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees). Similarly, any previously deferred costs and fees should be expensed if a contemplated debt offering is aborted (including an anticipated debt offering that is postponed for more than 90 days; see Section 5.2).

5.3.2.2 Nonrevolving Loan Commitment Fees

As discussed in Section 2.3.3, a commitment to obtain debt financing usually is exempt from derivative accounting requirements in accordance with the scope exception in ASC 815-10-15-69. It is generally appropriate for an entity to defer fees and costs it has paid for a commitment to obtain nonrevolving debt as an asset until the related debt is drawn. The potential debtor’s deferral of loan commitment costs and fees as an asset is analogous to the creditor’s treatment of fees received for a loan commitment under ASC 310-20-25-11, which generally requires commitment fees to be deferred. If all or a portion of the total commitment amount is funded, a proportionate amount of the commitment
asset reduces the initial net carrying amount of the funded debt. This accounting treatment is different from that for revolving loan commitment fees (see Section 5.4).

If a term loan commitment is cancelled or terminates, the related commitment costs and fees are immediately expensed. Expense recognition is also required if it becomes probable that (1) the debtor will not meet all of the conditions that it must satisfy to draw down on a commitment or (2) the creditor will not be financially capable of honoring the commitment.

### 5.3.2.3 Shelf Registration Costs and Fees

<table>
<thead>
<tr>
<th>Nonauthoritative AICPA Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Technical Q&amp;As Section 4110, “Issuance of Capital Stock”</strong></td>
</tr>
<tr>
<td><strong>.10 Costs Incurred in Shelf Registration</strong></td>
</tr>
<tr>
<td><strong>Inquiry</strong> — A public company incurs legal and other fees in connection with an SEC filing for a stock issue it plans to offer under a shelf registration. How should the company account for these costs?</td>
</tr>
<tr>
<td><strong>Reply</strong> — The costs should be capitalized as a prepaid expense. When securities are taken off the shelf and sold, a portion of the costs attributable to the securities sold should be charged against paid in capital. Any subsequent costs incurred to keep the filing “alive” should be charged to expense as incurred. If the filing is withdrawn, the related capitalized costs should be charged to expense.</td>
</tr>
</tbody>
</table>

A shelf registration permits a company to issue securities in one or more separate future offerings, with the size and price determined at the time of sale. AICPA Technical Q&As Section 4110.10 addresses the accounting for “legal and other fees in connection with an SEC filing for a stock issue [a public company] plans to offer under a shelf registration.” It is appropriate to apply this guidance by analogy to the costs and fees incurred by an entity to set up a shelf registration of debt securities. Under the AICPA’s guidance, the initial shelf registration costs are capitalized as a prepaid expense (i.e., deferred as an asset). When the entity issues securities under the shelf, an appropriate portion of the deferred costs is reclassified as a debt issuance cost of the issued debt. For example, deferred costs might be allocated to current and future debt offerings on the basis of estimates of the amount of debt the entity might issue under the shelf over its expected life. Any subsequent costs to maintain the shelf registration (i.e., to keep it “alive”) are charged to expense as incurred. If the filing is withdrawn or expires, any remaining capitalized costs should be immediately expensed. If an entity incurs costs and fees in connection with a shelf registration but it becomes probable that the entity will not use it, the entity should immediately expense any related costs and fees, including any previously deferred costs, in a manner consistent with the guidance on loss contingencies in ASC 450-20-25-2 (see Deloitte’s *A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees*).

### 5.3.3 Accounting for Costs and Fees Upon Debt Issuance

#### 5.3.3.1 Debt Issuance Costs

<table>
<thead>
<tr>
<th>ASC 835-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-1A</strong> [D]ebt issuance costs related to a note shall be reported in the balance sheet as a direct deduction from the face amount of that note. [D]ebt issuance costs shall not be classified as a deferred charge . . . .</td>
</tr>
</tbody>
</table>

Debt issuance costs must be presented as a direct deduction from the carrying amount of a debt liability. Therefore, such costs are treated in the same manner as a debt discount (see Section 4.3.6).
Example 5-1

Initial Recognition of Debt Issuance Costs

Entity D issues long-term debt at par for cash proceeds of $100 million. It incurs $1 million of debt issuance costs. Therefore, D makes the following entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>99,000,000</td>
</tr>
<tr>
<td>Long-term debt (debt issuance costs)</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Long-term debt (principal amount)</td>
<td>100,000,000</td>
</tr>
</tbody>
</table>

Before the adoption of ASU 2015-03, entities presented debt issuance costs as deferred charges (i.e., assets). This accounting is no longer acceptable unless the debt has not yet been issued (see Section 5.3.2) or the costs are related to line-of-credit or revolving-debt arrangements (see Section 5.4).

After the issuance of the debt, debt issuance costs are amortized as additional interest expense over the life of the debt in a manner similar to a debt discount (see Section 6.2) unless the issuer has elected the fair value option in ASC 825-10 for the debt, in which case any up-front costs and fees are expensed as incurred (see Section 5.5).

5.3.3.2 Fees and Other Amounts Paid to the Creditor

Accordingly, such amounts are treated as an increase to a debt discount or a reduction in a debt premium and not as an issuance cost. Examples of such amounts include origination fees, commitment fees, reimbursement of the creditor’s expenses, and other amounts paid to the creditor in connection with the issuance of the debt. Depending on the relationship between the debtor and creditor, amounts paid to the creditor could represent a dividend or other equity distribution (see Section 3.3.3.4). An entity should use judgment and consider the particular facts and circumstances when determining what these amounts represent.

In some situations, an amount paid to a creditor may represent compensation for services associated with the issuance of the debt to parties other than the creditor. Such amounts may be appropriately
characterized as debt issuance costs. For example, some portion of the total fees paid to a lead financial institution in a syndicated loan with multiple lenders (see Section 10.3.2.4) may represent arrangement fees associated with the placement of debt to other participating lenders (such amounts represent debt issuance costs). Issuers of debt will need to use judgment on the basis of the particular facts and circumstances to determine whether a portion of fees paid to a lead bank should be treated as debt issuance costs and, if so, how that amount is determined. In making this determination, entities should be mindful that a lead bank may pass on fees it receives to participating banks in a syndication. Such fees would not represent debt issuance costs since the lead bank is merely functioning as an agent to pass on fees to other lenders in the arrangement.

5.3.4 Accounting After Debt Issuance

<table>
<thead>
<tr>
<th>ASC 835-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-3</strong> Amortization of discount or premium shall be reported as interest expense in the case of liabilities or as interest income in the case of assets. Amortization of debt issuance costs also shall be reported as interest expense.</td>
</tr>
</tbody>
</table>

Unless a debt instrument is subsequently measured at fair value on a recurring basis (see Section 5.5), any debt issuance costs reduce the instrument’s initial net carrying amount in a manner similar to a debt discount (see Section 4.3.6). Under ASC 835-30-45-3, both debt discount and debt issuance costs must be amortized and reported as interest expense. Further, ASC 470-50-40-18(a), which addresses the accounting for modifications and exchanges of debt instruments (see Chapter 10), implies that debt issuance costs should be amortized by using the interest method. It states, in part:

> Costs incurred with third parties . . . shall be associated with the new debt instrument and amortized over the term of the new debt instrument using the interest method in a manner similar to debt issue costs.

Accordingly, entities should reflect eligible debt issuance costs as an adjustment to the initial proceeds received in the calculation of the debt’s original effective interest rate (see Section 6.2.3).

5.4 Costs and Fees Associated With Revolving Debt

<table>
<thead>
<tr>
<th>ASC 835-30 — SEC Materials — SEC Staff Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SEC Staff Announcement: Presentation and Subsequent Measurement of Debt Issuance Costs Associated With Line-of-Credit Arrangements</strong></td>
</tr>
<tr>
<td><strong>S45-1</strong> On April 7, 2015, the FASB issued Accounting Standards Update 2015-03, Interest — Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which requires entities to present debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability. The guidance in Update 2015-03 (see paragraph 835-30-45-1A) does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance within Update 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement.</td>
</tr>
</tbody>
</table>
ASC 835-30-45-1A does not apply to costs incurred in connection with line-of-credit or revolving-debt arrangements (whether drawn or undrawn). The terms of such arrangements permit the amount of debt outstanding to fluctuate by giving the borrower an option to borrow, repay, and reborrow amounts up to a specified maximum amount (see Section 2.3.3). Economically, issuance costs incurred are attributable to the overall credit facility rather than any specific amount drawn.

At the June 18, 2015, EITF meeting, the SEC staff confirmed that ASC 835-30, as amended by ASU 2015-03, “does not address the presentation and subsequent measurement of debt issuance costs related to line-of-credit arrangements” and announced that it would “not object to an entity deferring and presenting [such] costs as an asset and subsequently amortizing the . . . costs ratably over the term of the line-of-credit arrangement.” Accordingly, it would generally be appropriate for an entity to present specific incremental costs and fees that are directly attributable to a line of credit or other revolving-debt arrangement as a deferred charge (i.e., an asset) notwithstanding the prohibition in ASC 835-30-45-1A against classifying debt issuance costs as a deferred charge. The presentation of a deferred charge is appropriate irrespective of whether such costs and fees are paid to the creditor or third parties.

Generally, it is appropriate to use a straight-line method of amortizing such fees and costs over the term of the arrangement because the SEC staff announcement refers to amortizing such costs “ratably.” Further, straight-line amortization is supported by analogy to the creditor’s accounting under ASC 310-20-55-8(c), which states:

The following amortization methods shall be applied to the associated types of loan arrangements: . . .

c. Line of credit loans or arrangements with similar characteristics: straight-line method.

Under the method outlined by the SEC staff on June 18, 2015, an entity presents unamortized debt issuance costs associated with a line-of-credit or revolving-debt arrangement as an asset even if the entity currently has a recognized debt liability for amounts outstanding under the arrangement. Further, the entity amortizes such costs over the life of the arrangement irrespective of whether it repays previously drawn amounts.

The SEC staff announcement does not address whether other accounting policies might be acceptable (e.g., reclassifying unamortized costs as a reduction of the related liability once amounts are drawn). Entities are strongly encouraged to consult with their accounting advisers before (1) electing an accounting policy that could result in a write-off of remaining unamortized costs before the end of the arrangement’s term or (2) presenting a negative liability balance for the arrangement (e.g., when unamortized costs exceed the amount drawn or previously drawn amounts are repaid).

The guidance in this section does not apply to debt for which the issuer has elected the fair value option in ASC 815-15 or ASC 825-10 (see Section 5.5). If a transaction involves multiple units of account, the issuer should allocate the related issuance costs among those units of account (see Section 3.5).

For a discussion of the accounting for deferred costs and fees associated with a line-of-credit or revolving-debt arrangement upon a modification or exchange of such an arrangement, see Section 10.6.
5.5 Fair Value Option

**ASC 825-10**

25-3 Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred.

**ASC 820-10**

35-9B The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs shall be accounted for in accordance with other Topics. Transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how a reporting entity enters into a transaction for the asset or liability.

If an entity elects the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4) for an item, it must recognize any up-front costs and fees in earnings as incurred and not deferred. This requirement is consistent with the guidance in ASC 820-10-35-9B, which indicates that transaction costs are not part of a fair value measurement. As a result of the requirement to expense rather than defer up-front costs and fees associated with accounting for debt at fair value by using the fair value option, the reported amount of interest expense, if separately reported, will differ from the amount that would be reported if the same liability is accounted for by using the interest method.
Chapter 6 — Subsequent Accounting for Debt

6.1 Background
This chapter describes how an entity applies the interest method in ASC 835-30 (see Section 6.2 below) and the fair value option in ASC 825-10 (see Section 6.3) to the subsequent accounting for debt. The evaluation of whether features embedded in debt must be separated and accounted for as derivatives under ASC 815-15 is addressed in Chapter 8. Chapter 7 discusses specialized accounting models that apply to certain types of debt.

6.2 Interest Method

6.2.1 Background

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interest Method</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 835-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-5</strong> The total amount of interest during the entire period of a cash loan is generally measured by the difference between the actual amount of cash received by the borrower and the total amount agreed to be repaid to the lender. . . .</td>
</tr>
</tbody>
</table>

Under the interest method, an entity uses present value techniques (see Section 4.3.3) to determine the net carrying amount of the debt and the amount of periodic interest cost. The difference between the net amount the debtor receives upon issuing debt and the aggregate undiscounted amount it is required to pay as principal and interest over the debt's life represents the total interest cost on the debt. The total interest cost over the debt's life is allocated to individual reporting periods by using the effective yield implicit in the debt's contractual cash flows (see Section 6.2.3.3). Through this allocation, any premium or discount (see Section 4.3.6) and debt issuance costs (see Section 5.3) are amortized as interest cost over the debt's life (see Section 6.2.4).

The debt's net carrying amount at any point in time is the sum of the present values of the debt's remaining future principal and interest payments, discounted at the debt's effective interest rate. Other methods of computing periodic interest cost may be used only if the results are not materially different from those calculated under the interest method (see Section 6.2.3.7). The issuer reports interest cost as interest expense unless the cost qualifies for capitalization as borrowing costs under ASC 835-20 (see Section 14.2.4). The scope of the interest method is addressed in Section 6.2.2.
6.2.2 Scope

ASC 835-30

45-1 The guidance in this Section does not apply to the amortization of premium and discount of assets and liabilities that are reported at fair value and the debt issuance costs of liabilities that are reported at fair value.

55-1 The guidance in the following paragraphs is not subject to the scope limitation in paragraph 835-30-15-3(b).

55-2 Generally accepted accounting principles (GAAP) require use of the interest method. . . .

Unless an issuer elects to account for a particular debt instrument under the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4), it must apply the interest method to that debt, including the amortization of any debt discount or premium and debt issuance costs. The interest method applies irrespective of whether the debt has any stated interest (e.g., the interest method applies to zero-coupon debt).

A debtor should evaluate whether features embedded in a debt contract (e.g., indexation, conversion, redemption, acceleration, extension, exchange, and contingent payment features) must be separately accounted for as derivatives under ASC 815-15 (see Chapter 8). When a derivative has been bifurcated from a debt host contract, the interest method applies to such contract but not to the embedded derivative (see Section 8.5). Further, an entity should evaluate whether it can apply one of the special accounting models within GAAP for certain types of debt, such as those for sales of future revenue, participating mortgages, or indexed debt (see Chapter 7).

6.2.3 Interest Method Mechanics

6.2.3.1 Background

This section addresses the following topics:

- The inputs necessary for application of the interest method (see Section 6.2.3.2).
- The calculation of the effective interest rate under the interest method (see Section 6.2.3.3).
- The calculation of periodic interest cost (see Section 6.2.3.4).
- The calculation of the net carrying amount of debt under the interest method (see Section 6.2.3.5).
- The accrual of interest cost between interest payment dates (see Section 6.2.3.6).
- The use of alternative methods (see Section 6.2.3.7).

Further, Section 6.2.3.8 contains comprehensive examples of the interest method’s application to the issuance of debt at a discount and at a premium.
6.2.3.2 **Inputs to the Interest Method**

To apply the interest method, an entity must determine the debt's initial net carrying amount and the timing and amount of the debt's contractual cash flows:

- **Initial net carrying amount** — Chapter 4 discusses the initial measurement of debt, and Chapter 5 addresses the treatment of debt issuance costs. In the application of the interest method, the amount of proceeds and subsequent cash flows that are used to compute the effective interest rate are based on the amounts allocated to the debt host contract after separation of any embedded derivative (see Chapter 8) and any equity component (see Section 7.6).

- **Contractual cash flows** — The timing and amount of the debt's contractual cash flows are based on the debt's contractual terms. The application of the interest method does not depend on whether such cash flows are designated as principal, interest, premium, discount, or fees.

Some debt instruments require the debtor to pay an exit fee or repayment premium at maturity (e.g., 8 percent of the debt's principal amount). If the payment of such an amount is mandatory upon repayment of the debt, it should be incorporated into the contractual cash flows that are used to apply the interest method. However, an entity should evaluate exit fees and repayment premiums that are contingent or variable to determine whether they must be accounted for separately under ASC 815-15 (see Chapter 8) and, if not, whether special interest recognition guidance applies (see Chapter 7). Special considerations are necessary when the timing or amount of the cash flows on debt is variable (see Sections 6.2.4 and 6.2.5).

The stated interest rate on debt may be fixed over the debt's life; however, some debt instruments have interest-free periods or different fixed rates during the term of the debt. In these circumstances, proper application of the interest method will result in a constant effective yield throughout the entire term of the debt. Some debt instruments contain interest terms that vary on the basis of a reference rate (e.g., a prime rate or benchmark rate) and a margin. Section 6.2.5.2 discusses the application of the interest method to variable-rate debt.

In the United States, interest on fixed-rate corporate bonds is often paid semiannually in two equal installments. However, other payment frequencies are also common (e.g., monthly, quarterly, or annually). For some debt instruments (e.g., short-term commercial paper and zero-coupon bonds), no periodic interest payments are made. Further, different day-count conventions exist for determining the number of days between interest payments. For example, under the contractual terms, it might be assumed that a year has 360 days consisting of twelve 30-day months. Alternatively, it might be assumed that a year has 365 days (or 366 days in a leap year). To appropriately determine the timing and amount of a debt instrument's contractual cash flows, an entity should consider such terms and conventions.

Typically, the application of the interest method is based on the contractual cash flows produced until the debt's contractual maturity date. However, a shorter period may be appropriate for certain debt that is puttable by the creditor before maturity (see Section 6.2.4.2).

6.2.3.3 **Effective Interest Rate**

The debt's effective interest rate is the interest rate that is implicit in the terms of the debt (i.e., the internal rate of return of the debt's initial carrying amount determined on the basis of the contractual cash flows over the debt's life). The effective interest rate often differs from the debt's stated interest rate because of premiums, discounts, or debt issuance costs (see Section 6.2.3.2 above). The effective interest rate would also differ from the stated rate on debt that has an interest-free period or contains an interest rate that increases over the debt's life.
The effective interest rate can be determined by using a software application (e.g., the internal rate of return function in a spreadsheet program), a calculator, present value tables, or iterative numerical techniques. Mathematically, the effective interest rate is calculated by solving for the discount rate that equates the debt's initial net carrying amount to the contractual cash flows over the debt's life. Algebraically, this can be expressed as a discounted cash flow equation in which $P_0$ is the debt's initial net carrying amount, $CF_t$ is the debt's principal and interest cash outflows in each time period $t$ until the final cash outflow in time period $T$ (i.e., $t = 1, 2, 3, \ldots, T$), and $r$ is the effective interest rate that is used to discount those cash flows:

$$P_0 = \sum_{t=1}^{T} \frac{CF_t}{(1 + r)^t}$$

Alternatively, if the initial net carrying amount is treated as a negative cash outflow (i.e., $P_0 = -CF_0$), the equation can be simplified as follows:

$$\sum_{t=0}^{T} \frac{CF_t}{(1 + r)^t} = 0$$

Example 6-1

Calculation of Effective Interest Rate

In December 20X0, Entity R receives net proceeds of $940,000 for the issuance of a one-year debt instrument with a stated principal amount of $1 million that is repayable at maturity. The debt instrument pays interest in arrears at a stated annual rate of 10 percent of the principal amount, payable quarterly in arrears. Accordingly, R pays $25,000 at the end of each quarter ([$1 million \times 10\%] / 4). To determine the periodic (quarterly) effective interest rate, R sets up the following discounted cash flow equation:

$$\$940,000 = \frac{\$25,000}{(1 + r)^1} + \frac{\$25,000}{(1 + r)^2} + \frac{\$25,000}{(1 + r)^3} + \frac{\$1,000,000 + \$25,000}{(1 + r)^4}$$

$$r \approx 4.16\%$$

As shown above, the quarterly effective interest rate is 4.16 percent, or an annual effective rate of 16.64 percent. The difference between the effective rate and the cash interest paid equals the periodic amortization of the discount on the debt.
6.2.3.4 Periodic Interest Cost

<table>
<thead>
<tr>
<th>ASC 835-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-1 This Section provides guidance for the measurement of interest income or expense over the term of a note.</td>
</tr>
<tr>
<td>35-2 With respect to a note for which the imputation of interest is required, the difference between the present value and the face amount shall be treated as discount or premium and amortized as interest expense or income over the life of the note 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. This is the interest method.</td>
</tr>
<tr>
<td>35-3 The difference between the periodic interest cost so calculated using the interest method and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization.</td>
</tr>
<tr>
<td>35-5 The amount chargeable to interest expense under the guidance in this Subtopic is eligible for inclusion in the amount of interest cost capitalized in accordance with Subtopic 835-20.</td>
</tr>
<tr>
<td>45-3 Amortization of discount or premium shall be reported as interest expense in the case of liabilities or as interest income in the case of assets. Amortization of debt issuance costs also shall be reported as interest expense.</td>
</tr>
<tr>
<td>55-3 The interest method produces periodic interest income at a constant effective yield on a loan. . . .</td>
</tr>
</tbody>
</table>

Over the life of a debt instrument, the total amount of interest cost equals the difference between the debt's initial net carrying amount and the total contractual payments owed. As a result of discounts, premiums, or debt issuance costs, the amount that is reported as interest cost differs, both cumulatively and in specific financial reporting periods, from the amount contractually designated as interest cost.

To determine the periodic amount of interest cost and the amortization of any discount, premium, or debt issuance costs, an entity applies the effective interest rate to the net carrying amount of the debt as of the beginning of the period. That is, the amount of reported interest cost equals the product of (1) the net carrying amount at the beginning of the period and (2) the periodic effective interest rate.

\[
\text{Net Carrying Amount at Beginning of Period} \times \text{Periodic Effective Interest Rate} = \text{Interest Cost During Period}
\]

In each financial reporting period, any premium or discount (including debt issuance costs) is amortized as an adjustment to interest cost. If the amount of interest actually paid in cash differs from the amount of interest accrued, the difference is used to adjust the amount of the remaining unamortized discount or premium.

\[
\text{Interest Cost} - \text{Interest Paid} = \text{Amortization of Discount or Premium}
\]
The amortization of a debt discount increases reported interest cost relative to the amount of interest paid, whereas the amortization of a debt premium reduces reported interest cost.

### Example 6-2

**Amortization of Discount**

Assume the same facts as in Example 6-1 and that during the period between January 1, 20X1, and March 31, 20X1, Entity R accrues $39,096 ($940,000 × 0.0416) of interest cost even though it pays only $25,000 of cash interest at the end of that quarter. The difference of $14,096 reduces the amount of the remaining unamortized discount (i.e., it increases the net carrying amount of the debt instrument).

The full discount amortization schedule for R’s debt instrument is shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Cost</th>
<th>Discount Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X0</td>
<td>$(940,000)</td>
<td>—</td>
<td>—</td>
<td>$940,000</td>
</tr>
<tr>
<td>3/31/20X1</td>
<td>25,000</td>
<td>39,096</td>
<td>14,096</td>
<td>954,096</td>
</tr>
<tr>
<td>6/30/20X1</td>
<td>25,000</td>
<td>39,682</td>
<td>14,682</td>
<td>968,778</td>
</tr>
<tr>
<td>9/30/20X1</td>
<td>25,000</td>
<td>40,293</td>
<td>15,293</td>
<td>984,071</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>1,025,000</td>
<td>40,929</td>
<td>15,929</td>
<td>—</td>
</tr>
</tbody>
</table>

**6.2.3.5 Net Carrying Amount**

Under the interest method, the debt’s net carrying amount at any point in time equals the sum of the stated principal amount plus any remaining unamortized premium less any remaining unamortized discount (including issuance costs). The debt’s net carrying amount at the end of any financial reporting period can be determined as follows:

Mathematically, the debt’s net carrying amount at any point in time equals the present value of its remaining future cash flows, discounted by using the debt’s effective interest rate. Algebraically, this can be represented as follows (with \( BV_0 \) denoting the net carrying amount (“book value”) on date \( t = 0 \)):

\[
BV_0 = \sum_{t=1}^{T} \frac{CF_t}{(1 + r)^t}
\]
Example 6-3

**Calculation of Net Carrying Amount**

Assume the same facts as in Example 6-2. Immediately after the interest payment on June 30, 20X0, Entity R determines the debt’s net carrying amount by adding the amount of the discount amortized (i.e., the excess of interest expense accrued over interest paid) to the net carrying amount at the beginning of the period (i.e., $954,096 + $14,682 = $968,778).

Alternatively, R can determine the net carrying amount by calculating the present value of the remaining cash flows, discounted by the effective interest rate:

\[
BV_0 = \sum_{t=1}^{n} \frac{CF_t}{(1 + r)^t} = \frac{25,000}{(1 + 0.0416)^2} + \frac{1,025,000}{(1 + 0.0416)^2} = 968,778
\]

Although the carrying amount of a debt instrument for which the issuer has not elected the fair value option in ASC 825-10 is not remeasured for changes in its fair value, an adjustment to the net carrying amount is required when a debt instrument is designated as a hedged item in a fair value hedge (see Section 14.2.1.2). For a discussion of foreign-denominated debt, see Section 14.2.3.

6.2.3.6 **Accrual Between Payment Dates**

If an entity issues financial statements between payment dates, it must accrue interest payable and amortize any debt discount or premium and debt issuance costs for the period since the last adjustment. In practice, this allocation is sometimes performed on a time-proportionate basis (e.g., on the basis of the number of days elapsed since the last payment date as a fraction of the total number of days in the period between the payment dates). However, if the effect of discounting would be material, the interest method should be strictly applied to the adjustment.

Example 6-4

**Accrual of Interest**

Entity A issues a 15-year bond on March 31, 20X1, at par for cash proceeds of $40 million. No debt issuance costs were incurred. The stated coupon rate is 5 percent per annum, payable semiannually in arrears. Accordingly, A has an obligation to make semiannual interest payments of $1 million ($40,000,000 × 5% × 0.5). Entity A makes the following entry on March 31:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>40,000,000</td>
</tr>
<tr>
<td>Bond payable</td>
<td>40,000,000</td>
</tr>
</tbody>
</table>

Because the bond was issued at par and no debt issuance costs were incurred, the stated rate equals the effective interest rate that is used to recognize interest expense for financial reporting purposes. During the period from March 31 to September 30, A accrues interest of $1 million as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Accrued interest payable</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>
Example 6-4 (continued)

On September 30, A makes its first semiannual interest payment of $1 million and the following entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued interest payable</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

On December 31, A issues financial statements. On a time-proportionate basis, A would have accrued interest of $500,000 ($1,000,000 × 0.5) for the period from September 30 to December 31:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Accrued interest payable</td>
<td></td>
<td>500,000</td>
</tr>
</tbody>
</table>

Under a strict application of the interest method, the amount of interest expense is $502,762 for the period because there are 91 days between October 1, 20X1, and December 31, 20X1, as compared with 181 total days in this interest period:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>502,762</td>
<td></td>
</tr>
<tr>
<td>Accrued interest payable</td>
<td></td>
<td>502,762</td>
</tr>
</tbody>
</table>

6.2.3.7 Use of Alternative Methods

6.2.3.7.1 General

ASC 835-30

35-4 Other methods of amortization may be used if the results obtained are not materially different from those that would result from the interest method.

55-1 The guidance in the following paragraphs is not subject to the scope limitation in paragraph 835-30-15-3(b).

55-2 . . . There is no basis for using an alternative to the interest method except if the results of alternative methods do not differ materially from those obtained by using the interest method. Therefore, methods other than the interest method, such as the rule of 78s, sum of the years' digits, and straight-line methods shall not be used if their results materially differ from the interest method.

55-3 The interest method produces periodic interest income at a constant effective yield on a loan; therefore, in a lending arrangement in which interest collected in earlier periods will be greater than that computed using the interest method, the excess interest collected shall be deferred and recognized as interest income in later periods so as to produce a constant yield. For example, the interest method would be applied in this way to loans for which interest is collected by the sum of the years' digits method.

In determining the amount of interest to be recognized in each financial reporting period, an entity may use an approach other than the interest method (e.g., straight-line amortization) only if the results would not be materially different from those calculated by using the interest method. The interest method must be applied even if the contractual terms of the debt instrument require the use of a different means of allocating payments between amounts designated as principal repayments and those designated as interest payments.
Generally, the total amount of interest reported over the entire life of a debt instrument should not differ on the basis of the method used to recognize interest in individual periods, but the amounts reported in each individual period may be different. For example, straight-line amortization of a debt discount results in greater amortization in earlier periods and lower amortization in later periods than the interest method. If an entity uses an approach other than the interest method, it must assess whether the results are materially different in each individual period. If the results are materially different in any individual period, the interest method must be applied.

6.2.3.7.2 Straight-Line Amortization

Under the straight-line method, any debt discount or premium and debt issuance costs for a nonamortizing loan are amortized in equal periodic amounts over the life of the debt instrument. For example, if the debt discount for a five-year $1,000 loan is $25, a fifth of that amount ($5) is amortized to interest expense each year. This differs from the interest method, which typically requires entities to amortize discounts at an increasing amount over time and amortize premiums at a decreasing amount over time. Under the interest method, the amount of discounts or premiums amortized in each period differs because a constant effective interest rate is applied to a changing net carrying amount that is updated over time for the amortization of discounts or premiums. As discussed in Section 6.2.3.7.1, use of the straight-line method for amortizing debt discounts and debt premiums is acceptable only if the results are not materially different from those calculated under the interest method.

**Example 6-5**

**Interest Method Compared With Straight-Line Method**

Under the straight-line method, the discount amortization schedule is as follows for a two-and-a-half year $100,000 debt instrument that was issued for net proceeds of $95,000 and has a stated coupon rate of 12 percent per annum, payable semiannually in arrears:

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Reported Interest</th>
<th>Discount Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/30/20X0</td>
<td>(95,000)</td>
<td></td>
<td></td>
<td>95,000</td>
</tr>
<tr>
<td>12/31/20X0</td>
<td>6,000</td>
<td>$ 7,000</td>
<td>$ 1,000</td>
<td>96,000</td>
</tr>
<tr>
<td>6/30/20X1</td>
<td>6,000</td>
<td>7,000</td>
<td>1,000</td>
<td>97,000</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>6,000</td>
<td>7,000</td>
<td>1,000</td>
<td>98,000</td>
</tr>
<tr>
<td>6/30/20X2</td>
<td>6,000</td>
<td>7,000</td>
<td>1,000</td>
<td>99,000</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>106,000</td>
<td>7,000</td>
<td>1,000</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$35,000</td>
<td>$35,000</td>
<td>$5,000</td>
<td></td>
</tr>
</tbody>
</table>
Example 6-5 (continued)

Under the interest method, the discount amortization schedule for the same debt instrument is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Reported Interest</th>
<th>Discount Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/30/20X0</td>
<td>$(95,000)</td>
<td></td>
<td></td>
<td>$95,000.00</td>
</tr>
<tr>
<td>12/31/20X0</td>
<td>6,000</td>
<td>$6,865.52</td>
<td>$865.52</td>
<td>95,865.52</td>
</tr>
<tr>
<td>6/30/20X1</td>
<td>6,000</td>
<td>6,928.08</td>
<td>928.08</td>
<td>96,793.60</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>6,000</td>
<td>6,995.15</td>
<td>995.15</td>
<td>97,788.75</td>
</tr>
<tr>
<td>6/30/20X2</td>
<td>6,000</td>
<td>7,067.07</td>
<td>1,067.07</td>
<td>98,855.82</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>106,000</td>
<td>7,144.18</td>
<td>1,144.18</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$35,000</td>
<td>$35,000.00</td>
<td>$5,000.00</td>
<td></td>
</tr>
</tbody>
</table>

### Reported Interest

Periodic effective interest rate 7.23%

6.2.3.7.3 Rule of 78s

Another alternative method identified in ASC 835-30-55-2 for calculating principal and interest portions of debt is the rule of 78s. Under this method, an entity first calculates the sum of the digits (SD) for the number of remaining payments scheduled to be made by the debtor over the debt's life. For example, for a six-month loan that will be repaid in six equal monthly installments, the SD is 21 (1 + 2 + 3 + 4 + 5 + 6 = 21). The SD can also be determined by using the following formula in which \( N \) is the total number of payments:

\[
SD = \frac{N \times (N + 1)}{2} = \frac{6 \times (6 + 1)}{2} = 21
\]

The method is called the rule of 78s because the SD for a loan that will be repaid in 12 monthly payments is 78 \( \left[\frac{12 \times (12 + 1)}{2}\right] = 78 \).

Next, the entity determines the total amount of interest to be paid over the life of the instrument by calculating the difference between the original principal amount and the total amount to be repaid over the life of the instrument. For example, if an entity borrows $12,000 and the total amount to be repaid is $12,600, the total amount of interest to be paid over the life of the loan is $600.

The amount of interest attributable to each period is determined by multiplying the total amount of interest over the life of the instrument by the fraction of the SD that is attributable to each period. For example, the fraction of the SD that is attributable to the first month of a six-month loan is 0.285 \( \left(\frac{6}{21}\right) = 0.285 \).

As discussed in Section 6.2.3.7.1, use of the rule of 78s for amortizing debt discounts and debt premiums is acceptable only if the results are not materially different from those calculated under the interest method.
Example 6-6

**Interest Method Compared With Rule of 78s Method**

Under the rule of 78s, the computation of interest for a six-month loan of $12,000 that will be repaid in six equal monthly installments totaling $12,600 is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Period</th>
<th>SD Fraction</th>
<th>Cash Flow</th>
<th>Reported Interest</th>
<th>Principal Reductions</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X0</td>
<td>0</td>
<td>—</td>
<td>$(12,000.00)</td>
<td>$12,000.00</td>
<td>$12,000.00</td>
<td></td>
</tr>
<tr>
<td>2/1/20X0</td>
<td>1</td>
<td>6/21</td>
<td>2,100.00</td>
<td>$171.43</td>
<td>$1,928.57</td>
<td>10,071.43</td>
</tr>
<tr>
<td>3/1/20X0</td>
<td>2</td>
<td>5/21</td>
<td>2,100.00</td>
<td>142.86</td>
<td>1,957.14</td>
<td>8,114.29</td>
</tr>
<tr>
<td>4/1/20X0</td>
<td>3</td>
<td>4/21</td>
<td>2,100.00</td>
<td>114.29</td>
<td>1,985.71</td>
<td>6,128.57</td>
</tr>
<tr>
<td>5/1/20X0</td>
<td>4</td>
<td>3/21</td>
<td>2,100.00</td>
<td>85.71</td>
<td>2,014.29</td>
<td>4,114.29</td>
</tr>
<tr>
<td>6/1/20X0</td>
<td>5</td>
<td>2/21</td>
<td>2,100.00</td>
<td>57.14</td>
<td>2,042.86</td>
<td>2,071.43</td>
</tr>
<tr>
<td>7/1/20X0</td>
<td>6</td>
<td>1/21</td>
<td>2,100.00</td>
<td>28.57</td>
<td>2,071.43</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>21</strong></td>
<td><strong>21/21</strong></td>
<td><strong>$600.00</strong></td>
<td><strong>$600.00</strong></td>
<td><strong>$12,000.00</strong></td>
<td></td>
</tr>
</tbody>
</table>

Under the interest method, the entity would compute the amount of interest on the basis of the effective interest rate, which is approximately 1.41 percent per month. This results in the following amortization schedule:

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Reported Interest</th>
<th>Principal Reductions</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X0</td>
<td>$(12,000.00)</td>
<td>$169.45</td>
<td>$1,930.55</td>
<td>$12,000.00</td>
</tr>
<tr>
<td>2/1/20X0</td>
<td>2,100.00</td>
<td>$142.19</td>
<td>1,957.81</td>
<td>8,111.64</td>
</tr>
<tr>
<td>3/1/20X0</td>
<td>2,100.00</td>
<td>114.54</td>
<td>1,985.46</td>
<td>6,126.18</td>
</tr>
<tr>
<td>4/1/20X0</td>
<td>2,100.00</td>
<td>85.11</td>
<td>2,013.49</td>
<td>4,112.69</td>
</tr>
<tr>
<td>5/1/20X0</td>
<td>2,100.00</td>
<td>58.07</td>
<td>2,041.93</td>
<td>2,070.76</td>
</tr>
<tr>
<td>6/1/20X0</td>
<td>2,100.00</td>
<td>29.24</td>
<td>2,071.43</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$600.00</strong></td>
<td><strong>$600.00</strong></td>
<td><strong>$600.00</strong></td>
<td><strong>$12,000.00</strong></td>
</tr>
</tbody>
</table>

**6.2.3.7.4 Sum-of-the-Years'-Digits Method**

Another alternative method identified in ASC 835-30-55-2 is the sum-of-the-years'-digits (SYD) method. The SYD method is similar to the rule of 78s except that the digits used to allocate total interest cost over the debt's life do not represent the number of remaining payments but rather the number of remaining years. The amount of interest attributable to each year is calculated by multiplying the total amount of interest over the instrument's life by the fraction of the SYD that is attributable to each year of the debt's life. Although ASC 835-30 refers to the SYD method as a potential alternative to the interest method for determining the amount of interest expense, it is more commonly known as an accelerated method for the depreciation of the deductible cost of a nonfinancial asset over its useful life for tax purposes. As discussed in Section 6.2.3.7.1, use of the SYD method is acceptable only if the results are not materially different from those calculated under the interest method.
6.2.3.8 Comprehensive Examples

Example 6-7

Debt Issued at Discount

Entity D issues a 10-year $100 million bond on March 31, 20X1, at a 4 percent discount for proceeds of $96 million. Further, D incurs debt issuance costs of $1 million. The stated coupon rate is 10 percent per annum, payable semiannually in arrears. Accordingly, D has an obligation to make semiannual interest payments of $5 million. It makes the following entry on March 31, 20X1:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>95,000,000</td>
</tr>
<tr>
<td>Bond payable (discount and debt issuance costs)</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Bond payable (principal amount)</td>
<td>100,000,000</td>
</tr>
</tbody>
</table>

Because the bond was issued at a discount and debt issuance costs were incurred, the stated interest rate differs from the effective interest rate. By solving for the rate that equates the initial net proceeds to the future contractual interest and principal cash flows (see Section 6.2.3.3), D determines that the periodic (semiannual) effective interest rate equals 5.42 percent. During the period from March 31 to September 30, A accrues interest of $5,144,694 ($95,000,000 × 5.42% = $5,144,694) and makes the following journal entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>5,144,694</td>
</tr>
<tr>
<td>Accrued interest payable</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Bond payable (discount and debt issuance costs)</td>
<td>144,694</td>
</tr>
</tbody>
</table>

On September 30, 20X1, D makes its first semiannual interest payment and recognizes the following entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued interest payable</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>5,000,000</td>
</tr>
</tbody>
</table>

During the period from September 30, 20X1, to March 31, 20X2, D accrues interest of $5,152,530 ([($95,000,000 + 144,694) × 5.42% = $5,152,530] as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>5,152,530</td>
</tr>
<tr>
<td>Accrued interest payable</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Bond payable (discount and debt issuance costs)</td>
<td>152,530</td>
</tr>
</tbody>
</table>

On March 31, 20X2, D makes its second semiannual interest payment and recognizes the following entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued interest payable</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>5,000,000</td>
</tr>
</tbody>
</table>
### Example 6-7 (continued)

The full discount amortization schedule for D's bond is shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Discount Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/31/20X1</td>
<td>$ (95,000,000)</td>
<td>$ —</td>
<td>$ —</td>
<td>$ 95,000,000</td>
</tr>
<tr>
<td>9/30/20X1</td>
<td>5,000,000</td>
<td>5,144,694</td>
<td>144,694</td>
<td>95,144,694</td>
</tr>
<tr>
<td>3/31/20X2</td>
<td>5,000,000</td>
<td>5,152,530</td>
<td>152,530</td>
<td>95,297,224</td>
</tr>
<tr>
<td>9/30/20X2</td>
<td>5,000,000</td>
<td>5,160,790</td>
<td>160,790</td>
<td>95,458,014</td>
</tr>
<tr>
<td>3/31/20X3</td>
<td>5,000,000</td>
<td>5,169,497</td>
<td>169,497</td>
<td>95,627,511</td>
</tr>
<tr>
<td>9/30/20X3</td>
<td>5,000,000</td>
<td>5,178,676</td>
<td>178,676</td>
<td>95,806,187</td>
</tr>
<tr>
<td>3/31/20X4</td>
<td>5,000,000</td>
<td>5,188,353</td>
<td>188,353</td>
<td>95,994,540</td>
</tr>
<tr>
<td>9/30/20X4</td>
<td>5,000,000</td>
<td>5,198,553</td>
<td>198,553</td>
<td>96,193,093</td>
</tr>
<tr>
<td>3/31/20X5</td>
<td>5,000,000</td>
<td>5,209,305</td>
<td>209,305</td>
<td>96,402,398</td>
</tr>
<tr>
<td>9/30/20X5</td>
<td>5,000,000</td>
<td>5,220,640</td>
<td>220,640</td>
<td>96,623,038</td>
</tr>
<tr>
<td>3/31/20X6</td>
<td>5,000,000</td>
<td>5,232,589</td>
<td>232,589</td>
<td>96,855,627</td>
</tr>
<tr>
<td>9/30/20X6</td>
<td>5,000,000</td>
<td>5,245,185</td>
<td>245,185</td>
<td>97,100,812</td>
</tr>
<tr>
<td>3/31/20X7</td>
<td>5,000,000</td>
<td>5,258,463</td>
<td>258,463</td>
<td>97,359,275</td>
</tr>
<tr>
<td>9/30/20X7</td>
<td>5,000,000</td>
<td>5,272,460</td>
<td>272,460</td>
<td>97,631,735</td>
</tr>
<tr>
<td>3/31/20X8</td>
<td>5,000,000</td>
<td>5,287,214</td>
<td>287,214</td>
<td>97,918,949</td>
</tr>
<tr>
<td>9/30/20X8</td>
<td>5,000,000</td>
<td>5,302,768</td>
<td>302,768</td>
<td>98,221,717</td>
</tr>
<tr>
<td>3/31/20X9</td>
<td>5,000,000</td>
<td>5,319,165</td>
<td>319,165</td>
<td>98,540,882</td>
</tr>
<tr>
<td>9/30/20X9</td>
<td>5,000,000</td>
<td>5,336,449</td>
<td>336,449</td>
<td>98,877,331</td>
</tr>
<tr>
<td>3/31/20Y0</td>
<td>5,000,000</td>
<td>5,354,669</td>
<td>354,669</td>
<td>99,232,000</td>
</tr>
<tr>
<td>9/30/20Y0</td>
<td>5,000,000</td>
<td>5,373,876</td>
<td>373,876</td>
<td>99,605,876</td>
</tr>
<tr>
<td>3/31/20Y1</td>
<td>105,000,000</td>
<td>5,394,124</td>
<td>394,124</td>
<td>—</td>
</tr>
</tbody>
</table>
Example 6-8

Debt Issued at a Premium

Entity P issues a five-year $10 million bond on March 31, 20X1, at a 4 percent premium for proceeds of $10.4 million. Further, P incurs debt issuance costs of $100,000. The stated coupon rate is 12 percent per annum, payable semiannually in arrears. Accordingly, P has an obligation to make semiannual interest payments of $600,000. Entity P makes the following entry on March 31, 20X1:

\[
\begin{align*}
\text{Cash} & \quad 10,300,000 \\
\text{Bond payable (principal amount)} & \quad 10,000,000 \\
\text{Bond payable (premium net of debt issuance costs)} & \quad 300,000
\end{align*}
\]

Because the bond was issued at net premium, the stated interest rate differs from the effective interest rate. By solving for the rate that equates the initial net proceeds to the future contractual interest and principal cash flows, P determines that the periodic (semiannual) effective interest rate equals 5.6 percent. During the period from March 31 to September 30, P accrues interest of $576,809 ($10,300,000 × 5.6% = $576,809) as follows:

\[
\begin{align*}
\text{Interest expense} & \quad 576,809 \\
\text{Bond payable (premium net of debt issuance costs)} & \quad 23,191 \\
\text{Accrued interest payable} & \quad 600,000
\end{align*}
\]

On September 30, 20X1, P makes its first semiannual interest payment and recognizes the following entry:

\[
\begin{align*}
\text{Accrued interest payable} & \quad 600,000 \\
\text{Cash} & \quad 600,000
\end{align*}
\]

During the period from September 30, 20X1, to March 31, 20X2, P accrues interest of $575,510 [($10,300,000 – $23,191) × 5.6% = $575,510] as follows:

\[
\begin{align*}
\text{Interest expense} & \quad 575,510 \\
\text{Bond payable (premium net of debt issuance costs)} & \quad 24,490 \\
\text{Accrued interest payable} & \quad 600,000
\end{align*}
\]

On March 31, 20X2, P makes its second semiannual interest payment and recognizes the following entry:

\[
\begin{align*}
\text{Accrued interest payable} & \quad 600,000 \\
\text{Cash} & \quad 600,000
\end{align*}
\]
Example 6-8 (continued)

The full premium amortization schedule for P's bond is shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Premium Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/31/20X1</td>
<td>$(10,300,000)</td>
<td>$</td>
<td>$</td>
<td>$ 10,300,000</td>
</tr>
<tr>
<td>9/30/20X1</td>
<td>600,000</td>
<td>576,809</td>
<td>23,191</td>
<td>10,276,809</td>
</tr>
<tr>
<td>3/31/20X2</td>
<td>600,000</td>
<td>575,510</td>
<td>24,490</td>
<td>10,252,319</td>
</tr>
<tr>
<td>9/30/20X2</td>
<td>600,000</td>
<td>574,138</td>
<td>25,862</td>
<td>10,226,457</td>
</tr>
<tr>
<td>3/31/20X3</td>
<td>600,000</td>
<td>572,690</td>
<td>27,310</td>
<td>10,199,147</td>
</tr>
<tr>
<td>9/30/20X3</td>
<td>600,000</td>
<td>571,161</td>
<td>28,839</td>
<td>10,170,308</td>
</tr>
<tr>
<td>3/31/20X4</td>
<td>600,000</td>
<td>569,546</td>
<td>30,454</td>
<td>10,139,854</td>
</tr>
<tr>
<td>9/30/20X4</td>
<td>600,000</td>
<td>567,840</td>
<td>32,160</td>
<td>10,107,694</td>
</tr>
<tr>
<td>3/31/20X5</td>
<td>600,000</td>
<td>566,039</td>
<td>33,961</td>
<td>10,073,733</td>
</tr>
<tr>
<td>9/30/20X5</td>
<td>600,000</td>
<td>564,138</td>
<td>35,862</td>
<td>10,037,871</td>
</tr>
<tr>
<td>3/31/20X6</td>
<td>10,600,000</td>
<td>562,129</td>
<td>37,871</td>
<td>—</td>
</tr>
</tbody>
</table>

6.2.4 Amortization Period

6.2.4.1 General

Although ASC 835-30-35-2 specifies that a discount or premium should be amortized over the debt's "life," it does not explicitly address whether life refers to the contractual term or some shorter period. In practice, life has been interpreted to mean the debt's full stated contractual term unless the debt is puttable by the creditor at an amount in excess of its accreted value before its stated maturity date (see Section 6.2.4.2).

Further, special amortization guidance applies to extendable increasing-rate debt (see Section 6.2.4.5) and convertible debt within the scope of the BCF or CCF guidance in ASC 470-20 (see Sections 6.2.4.6 and 6.2.4.7, respectively).
6.2.4.2 **Puttable Debt Involving a Discount**

For debt issued at a discount that is puttable by the creditor at an amount in excess of its accreted value (e.g., at an amount equal to or in excess of its stated principal amount), the debtor should amortize any debt discount and issuance costs from the date of issuance to the earliest stated date on which the creditor has a noncontingent right to exercise its put option. This means that in the calculation of the effective interest rate, it should be assumed that the debtor exercises the put option. From the debtor’s perspective, this is the highest possible yield that it could be forced to pay if the circumstances do not change. This guidance is supported by analogy to (1) the requirement in ASC 480-10-S99-3A(15)(a) to accrete changes in the redemption value of redeemable securities classified in temporary equity to the earliest redemption date (see Section 9.5.2.3 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*) and (2) the requirement in ASC 470-20-35-7(a) to accrete a discount on convertible debt that results from a BCF to the stated redemption date (see Section 6.2.4.7).

If debt becomes immediately due and payable because a mandatory redemption feature is triggered, any remaining unamortized debt discount and debt issuance costs should be recognized immediately as an expense. If a contingent put right is triggered (or it becomes probable that it will be triggered) so that the creditor obtains the right to exercise it (e.g., a creditor’s right to accelerate the repayment of debt upon a debt covenant violation), the debtor should assess whether it is necessary to accelerate the amortization of any remaining unamortized debt discount and issuance costs. If there is a reasonable likelihood that the creditor will not exercise the put feature (e.g., because the creditor has waived the debt covenant violation), continued amortization over the debt's full contractual term may be appropriate.

If the holder's ability to exercise a put option is contingent on circumstances beyond its control but the holder is expected to obtain the unilateral ability to exercise it, it is acceptable to amortize discounts and issuance costs over the period until the holder is expected to obtain such unilateral ability. If the creditor does not have a unilateral right to put the debt back to the company as of a specified date or on specified dates (e.g., the exercise of the put is contingent on an uncertain future event outside the creditor's control) and it is not probable that the put right will become exercisable by the creditor, any debt discount and debt issuance costs should be amortized over the debt's full contractual term. If debt is puttable at an amount less than its accreted value (e.g., a put option with a strike price that is less than the amount of net proceeds received), amortization of the discount over the full contractual term would also be appropriate since the debtor would not be paying the creditor for any discount or issuance costs upon the exercise of the put.
**Example 6-9**

**Puttable Debt Issued at a Discount**

Entity D issues a 10-year $60 million debt instrument on March 31, 20X1, at a 6 percent discount for net cash proceeds of $56.4 million. The stated coupon rate is 8 percent per annum, payable semiannually in arrears. Accordingly, D has an obligation to make semiannual interest payments of $2.4 million.

The holder has the unconditional right to put the debt back to P at par at any time after five years; therefore, the debt discount should be amortized over five years to ensure that its carrying amount is equal to the redemption amount on the earliest redemption date. Entity D computes the effective interest rate on the basis of a five-year life and determines that the periodic effective interest rate is 4.77 percent. The discount amortization schedule for D's debt is shown below:

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Amortization of Discount</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/31/20X1</td>
<td>(56,400,000)</td>
<td>—</td>
<td>—</td>
<td>56,400,000</td>
</tr>
<tr>
<td>9/30/20X1</td>
<td>2,400,000</td>
<td>2,689,326</td>
<td>289,326</td>
<td>56,689,326</td>
</tr>
<tr>
<td>3/31/20X2</td>
<td>2,400,000</td>
<td>2,703,122</td>
<td>303,122</td>
<td>56,992,448</td>
</tr>
<tr>
<td>9/30/20X2</td>
<td>2,400,000</td>
<td>2,717,576</td>
<td>317,576</td>
<td>57,310,024</td>
</tr>
<tr>
<td>3/31/20X3</td>
<td>2,400,000</td>
<td>2,732,719</td>
<td>332,719</td>
<td>57,642,743</td>
</tr>
<tr>
<td>9/30/20X3</td>
<td>2,400,000</td>
<td>2,748,584</td>
<td>348,584</td>
<td>57,991,327</td>
</tr>
<tr>
<td>3/31/20X4</td>
<td>2,400,000</td>
<td>2,765,206</td>
<td>365,206</td>
<td>58,356,533</td>
</tr>
<tr>
<td>9/30/20X4</td>
<td>2,400,000</td>
<td>2,782,620</td>
<td>382,620</td>
<td>58,739,153</td>
</tr>
<tr>
<td>3/31/20X5</td>
<td>2,400,000</td>
<td>2,800,864</td>
<td>400,864</td>
<td>59,140,017</td>
</tr>
<tr>
<td>9/30/20X5</td>
<td>2,400,000</td>
<td>2,819,979</td>
<td>419,979</td>
<td>59,559,995</td>
</tr>
<tr>
<td>3/31/20X6</td>
<td>2,400,000</td>
<td>2,840,004</td>
<td>440,004</td>
<td>60,000,000</td>
</tr>
<tr>
<td>9/30/20X6</td>
<td>2,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>60,000,000</td>
</tr>
<tr>
<td>3/31/20X7</td>
<td>2,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>60,000,000</td>
</tr>
<tr>
<td>9/30/20X7</td>
<td>2,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>60,000,000</td>
</tr>
<tr>
<td>3/31/20X8</td>
<td>2,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>60,000,000</td>
</tr>
<tr>
<td>9/30/20X8</td>
<td>2,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>60,000,000</td>
</tr>
<tr>
<td>3/31/20X9</td>
<td>2,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>60,000,000</td>
</tr>
<tr>
<td>9/30/20X9</td>
<td>2,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>60,000,000</td>
</tr>
<tr>
<td>3/31/20Y0</td>
<td>2,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>60,000,000</td>
</tr>
<tr>
<td>9/30/20Y0</td>
<td>2,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>60,000,000</td>
</tr>
<tr>
<td>3/31/20Y1</td>
<td>62,400,000</td>
<td>2,400,000</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>


6.2.4.3 **Puttable Debt Involving a Premium**

For debt that is issued at a premium to par and puttable by the creditor at an amount less than its accreted value (e.g., par), the debt premium should be amortized over the contractual life of the debt. It would not be appropriate to recognize the debt premium as a reduction of interest expense from the date of issuance to the earliest stated redemption date. ASC 450-30-25-1 provides analogous guidance:

>A contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization.

**Example 6-10**

**Puttable Debt Issued at a Premium**

Entity R issued debt at a premium with a 10-year term. The holder has the unconditional right to put the debt back to the company at par at any time after five years. Entity R should amortize the debt premium over the 10-year contractual life of the debt.

6.2.4.4 **Callable Debt**

Any discount or premium for debt that is prepayable or callable by the debtor (but is not puttable by the creditor) should be amortized over the contractual term of the debt (i.e., the debtor should not assume that it will exercise its call option).

**Example 6-11**

**Callable Debt Issued at a Discount**

Entity C issued two nonconvertible debt instruments. Both instruments have a 10-year term and were issued at a discount. The entity can call each debt instrument at par at any time after five years. The first debt instrument has an interest rate that "steps up" during the contractual term of the debt from 6 percent to 12 percent. The second debt instrument has an interest rate that is variable for five years and then becomes fixed for the remaining term. Neither of the debt instruments is puttable by the investor. For each instrument, C should amortize the related debt discount and any issuance cost over the full contractual term to the debt's maturity. Note that the application of the interest method to the debt with the interest rate step-up must take into account the contractual interest rate terms throughout the contractual life of the instrument.

6.2.4.5 **Extendable Increasing-Rate Debt**

**ASC 470-10**

35-1 A debt instrument may have a maturity date that can be extended at the option of the borrower at each maturity date until final maturity. In such cases, the interest rate on the note increases a specified amount each time the note is renewed. For guidance on accounting for interest, see Subtopic 835-30.

35-2 The borrower’s periodic interest cost shall be determined using the interest method based on the estimated outstanding term of the debt. In estimating the term of the debt, the borrower shall consider its plans, ability, and intent to service the debt. Debt issue costs shall be amortized over the same period used in the interest cost determination. The term-extending provisions of the debt instrument should be analyzed to determine whether those provisions constitute an embedded derivative that warrants separate accounting as a derivative under Subtopic 815-10.

45-8 If the debt is paid at par before its estimated maturity, any excess interest accrued shall be an adjustment of interest expense.
An exception to the requirement to amortize discounts and premiums over the contractual term applies to certain extendable increasing-rate debt instruments. (This guidance does not apply to debt with a term extension option that must be bifurcated as a derivative instrument under ASC 815-15; see Section 8.4.5.) In accordance with ASC 470-10-35-2, if a debt instrument has a contractual maturity date that can be extended at the issuer’s option at an increasing interest rate, the debt discounts and issuance costs must be amortized over the period in which the debt is estimated to be outstanding even if that period extends beyond the debt’s original contractual maturity date. That is, the effective interest rate is calculated on the basis of the estimated term of the debt.

If extendable increasing-rate debt is repaid at par before its estimated maturity, the issuer should not recognize a debt extinguishment gain for any excess interest accrued. Instead, ASC 470-10-45-8 requires the debtor to derecognize the excess interest accrued by adjusting the amount of reported interest expense.

### Example 6-12

**Increasing-Rate Debt**

Entity E issues a 90-day debt instrument at par for proceeds of $100 million. The interest rate is 5 percent per annum. Entity E has an option to extend the term for 90 days in each quarter at an increasing interest rate. If the term is extended, the interest rate increases by 0.5 percent in each quarter during the first year and 0.25 percent in each quarter after the first year. The estimated outstanding term of the debt is two years. Entity E determines that, if a two-year life is assumed, the effective (quarterly) interest rate under ASC 470-10-35-2 is 1.6 percent. The interest recognition schedule for this debt instrument is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Amortization of Premium</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/31/20X1</td>
<td>(100,000,000)</td>
<td>—</td>
<td>—</td>
<td>100,000,000</td>
</tr>
<tr>
<td>6/30/20X1</td>
<td>1,250,000</td>
<td>1,602,031</td>
<td>(352,031)</td>
<td>100,352,031</td>
</tr>
<tr>
<td>9/30/20X1</td>
<td>1,375,000</td>
<td>1,607,671</td>
<td>(232,671)</td>
<td>100,584,702</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>1,500,000</td>
<td>1,611,399</td>
<td>(111,399)</td>
<td>100,696,101</td>
</tr>
<tr>
<td>3/31/20X2</td>
<td>1,625,000</td>
<td>1,613,183</td>
<td>11,817</td>
<td>100,684,284</td>
</tr>
<tr>
<td>6/30/20X2</td>
<td>1,687,500</td>
<td>1,612,994</td>
<td>74,506</td>
<td>100,609,778</td>
</tr>
<tr>
<td>9/30/20X2</td>
<td>1,750,000</td>
<td>1,611,800</td>
<td>138,200</td>
<td>100,471,578</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>1,812,500</td>
<td>1,609,586</td>
<td>202,914</td>
<td>100,268,664</td>
</tr>
<tr>
<td>3/31/20X3</td>
<td>101,875,000</td>
<td>1,606,334</td>
<td>268,664</td>
<td>100,000,000</td>
</tr>
</tbody>
</table>

Even though debt with a borrower extension option (at an increased interest rate) is economically similar to a debt instrument with an interest rate that steps up over time and that the borrower may call before maturity, the guidance in ASC 470-10-35 does not apply to such callable debt. The guidance in ASC 470-10-35 on extendable increasing-rate debt represents an exception to the general interest recognition guidance in ASC 835-30. Discounts, premiums, and issuance costs related to callable, increasing-rate debt are amortized over the contractual term to maturity (see Section 6.2.4.4).
### Callable Increasing-Rate Debt

Entity C issues a note that is economically similar to Entity E's note in Example 6-12. However, C structures the note as a callable five-year increasing-rate note instead of a three-month instrument extendable at an increasing interest rate. Entity C issues the note at par for proceeds of $100 million. The initial interest rate is 5 percent per annum, payable quarterly. The interest rate increases by 0.5 percent in each quarter during the first year and 0.25 percent in each quarter after the first year. Under the call option, C has the right to prepay the debt at any time at par. The estimated outstanding term of the debt is two years. Entity C determines that the effective (quarterly) interest rate computed under ASC 835-30 is approximately 1.97 percent. The interest recognition schedule for this note is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Amortization of Premium</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/31/20X1</td>
<td>$(100,000,000)</td>
<td>$</td>
<td>—</td>
<td>$ 100,000,000</td>
</tr>
<tr>
<td>6/30/20X1</td>
<td>1,250,000</td>
<td>1,968,702</td>
<td>(718,702)</td>
<td>100,718,702</td>
</tr>
<tr>
<td>9/30/20X1</td>
<td>1,375,000</td>
<td>1,982,851</td>
<td>(607,851)</td>
<td>101,326,553</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>1,500,000</td>
<td>1,994,818</td>
<td>(494,818)</td>
<td>101,821,371</td>
</tr>
<tr>
<td>3/31/20X2</td>
<td>1,625,000</td>
<td>2,004,559</td>
<td>(379,559)</td>
<td>102,200,930</td>
</tr>
<tr>
<td>6/30/20X2</td>
<td>1,687,500</td>
<td>2,012,032</td>
<td>(324,532)</td>
<td>102,525,462</td>
</tr>
<tr>
<td>9/30/20X2</td>
<td>1,750,000</td>
<td>2,018,421</td>
<td>(268,421)</td>
<td>102,793,883</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>1,812,500</td>
<td>2,023,705</td>
<td>(211,205)</td>
<td>103,005,088</td>
</tr>
<tr>
<td>3/31/20X3</td>
<td>1,875,000</td>
<td>2,027,863</td>
<td>(152,863)</td>
<td>103,157,951</td>
</tr>
<tr>
<td>6/30/20X3</td>
<td>1,937,500</td>
<td>2,030,873</td>
<td>(93,373)</td>
<td>103,251,324</td>
</tr>
<tr>
<td>9/30/20X3</td>
<td>2,000,000</td>
<td>2,032,711</td>
<td>(32,711)</td>
<td>103,284,035</td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>2,062,500</td>
<td>2,033,355</td>
<td>29,145</td>
<td>103,254,890</td>
</tr>
<tr>
<td>3/31/20X4</td>
<td>2,125,000</td>
<td>2,032,781</td>
<td>92,219</td>
<td>103,162,671</td>
</tr>
<tr>
<td>6/30/20X4</td>
<td>2,187,500</td>
<td>2,030,966</td>
<td>156,534</td>
<td>103,006,137</td>
</tr>
<tr>
<td>9/30/20X4</td>
<td>2,250,000</td>
<td>2,027,884</td>
<td>222,116</td>
<td>102,784,021</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>2,312,500</td>
<td>2,023,511</td>
<td>288,989</td>
<td>102,495,032</td>
</tr>
<tr>
<td>3/31/20X5</td>
<td>2,375,000</td>
<td>2,017,822</td>
<td>357,178</td>
<td>102,137,854</td>
</tr>
<tr>
<td>6/30/20X5</td>
<td>2,437,500</td>
<td>2,010,790</td>
<td>426,710</td>
<td>101,711,144</td>
</tr>
<tr>
<td>9/30/20X5</td>
<td>2,500,000</td>
<td>2,002,389</td>
<td>497,611</td>
<td>101,213,533</td>
</tr>
<tr>
<td>12/31/20X5</td>
<td>2,562,500</td>
<td>1,992,593</td>
<td>569,907</td>
<td>100,643,626</td>
</tr>
<tr>
<td>3/31/20X6</td>
<td>102,625,000</td>
<td>1,981,374</td>
<td>643,626</td>
<td>—</td>
</tr>
</tbody>
</table>
Connecting the Dots

ASC 470-10 does not specifically address whether an issuer of extendable increasing-rate debt that uses the interest method should periodically update the debt’s estimated life. However, since ASC 470-10-45-8 acknowledges that there could be excess accrued interest as of the date such debt is repaid, we believe that there is no requirement for entities to reassess the estimated life that was determined on the debt’s issuance date. However, it would also be appropriate for an entity that uses the interest method to elect, as an accounting policy, to continually update the estimated life of extendable increasing-rate debt provided that the entity makes any necessary adjustments to periodic interest expense to which it applied a retrospective method (i.e., the cumulative interest cost reported in any financial reporting period-end is based on the updated effective yield).

6.2.4.6 Debt With a CCF

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

Special amortization guidance applies to convertible debt that is within the scope of the CCF guidance in ASC 470-20 (see Section 7.6.4). Under that guidance, entities must amortize the debt discount that is created as a result of the separation of a liability component under ASC 470-20 and any transaction costs allocated to the liability component by using the interest method over the expected life of a similar hypothetical nonconvertible debt instrument. Entities determine the expected life of the liability component on the basis of all substantive terms and features (e.g., substantive puts or calls) of the convertible debt other than the conversion feature (see Sections 6.3.2.4.1 and 6.4.1 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt). The amortization period is not subsequently reassessed unless the terms of the instrument are modified.

If an entity uses an income approach to determine the initial fair value of the liability component (e.g., discounted cash flows), it should use the same expected-life assumption to determine the appropriate amortization period for the debt discount and any associated debt issuance costs.
Chapter 6 — Subsequent Accounting for Debt

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. Unless special requirements apply, the amortization period for instruments outside the scope of the CCF guidance is usually the contractual life or the earliest noncontingent put date (see Section 6.2.4.1). Paragraph B15 of FSP APB 14-1 states, in part:

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.

6.2.4.7 Debt With a BCF

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>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:</td>
</tr>
<tr>
<td>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. . . .</td>
</tr>
<tr>
<td>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. . . .</td>
</tr>
<tr>
<td>c. 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>2. For convertible debt securities, that discount shall be recognized as interest expense using the effective yield method. . . .</td>
</tr>
</tbody>
</table>

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. . . .

Debt discounts and issuance costs associated with a convertible debt instrument that contains a BCF (see Section 7.6.5) 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 (see Section 7.4.2 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt).

While not directly addressed in ASC 470-20, discounts and issuance costs on 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 that ends on the first date on which the holder has or will obtain the unilateral ability to exercise the put option (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 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, it is acceptable to amortize discounts and issuance costs over the period until the holder is expected to obtain such unilateral ability (see also Section 6.2.4.2).
If the conversion price of a convertible debt instrument changes with the passage of time (see Section 7.4.3 of Deloitte's *A Roadmap to the Issuer's Accounting for Convertible Debt*), 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 the 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.

Convertible debt instruments almost always have a stated redemption date. As a result, the guidance in ASC 470-20-35-7(c) generally does not apply to them. 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, since the convertible instrument is classified as a liability, the effective yield method must be applied to the earliest conversion date (see Section 7.4.4 of Deloitte's *A Roadmap to the Issuer's Accounting for Convertible Debt*).

If the intrinsic value of a conversion feature is remeasured because of a conversion price adjustment that is recognized as a contingent BCF (see Section 7.5.2 of Deloitte's *A Roadmap to the Issuer's Accounting for Convertible Debt*), an entity is not permitted to reverse any previous amortization of a discount that resulted from such recognition. 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.

### 6.2.5 Debt With Contingent or Variable Cash Flows or Other Unique Features

#### 6.2.5.1 Background

Some debt instruments contain contractual features that could affect the timing or amount of the contractual cash flows or the settlement method (e.g., cash or equity shares). Such adjustments may be at the option of the counterparty (e.g., a put or redemption feature) or contingent on the occurrence or nonoccurrence of an event (e.g., noncompliance with a debt covenant). They may also be based on a price (e.g., a commodity or equity price, appraised value (e.g., mortgaged real estate), index (e.g., a stock market index), rate (e.g., consumer price index (CPI)), or other measure (e.g., the issuer's revenue, the cash flows from a mortgaged real estate project, or the cash flows from a pool of receivables). An entity should evaluate these types of features to determine whether they must be separated from the instrument as derivatives under ASC 815-15 (see Chapter 8).

If ASC 815-15 does not require separation and the issuer has not elected to account for the debt at fair value under ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4), the application of the interest method may need to be altered. Special accounting models apply to certain types of debt such as puttable debt (see Section 6.2.4.2), extendable increasing-rate debt (see Section 6.2.4.5), sales of future revenue (see Section 7.2), participating mortgages (see Section 7.3), indexed debt (see Section 7.4), and convertible debt (see Section 7.6). The application of the interest method to variable-rate debt is addressed in Section 6.2.5.2 and to paid-in-kind (PIK) interest in Section 6.2.5.3. If no other accounting literature is applicable, the debtor should consider the guidance on loss contingencies in ASC 450-20 (see Section 6.2.5.4) and gain contingencies in ASC 450-30 (see Section 6.2.5.5) to determine whether any accounting is required before a payment occurs. However, a debtor should accrue interest on the basis of the amounts that are contractually due even if the debtor is unable, or expects to be unable, to pay some or all of those amounts (see Section 6.2.5.6). Special considerations related to the application of the interest method to nonrecourse beneficial interest obligations are addressed in Section 6.2.5.7.
### 6.2.5.2 Variable-Rate Debt

If the stated interest rate of a debt instrument varies on the basis of changes in a reference interest rate index (such as the prime rate or benchmark interest rate), the debtor generally should accrue amounts designated in the debt agreement as interest in accordance with the interest rate in effect in each period as it changes over the debt's life. ASC 470-30-35-3, which addresses participating mortgages (see Section 7.3.5), states, in part:

Amounts designated in the mortgage agreement as interest shall be charged to income in the period in which the interest is incurred. If the loan's stated interest rate varies based on changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate [LIBOR], or the U.S. Treasury bill weekly average rate), the calculation of the interest shall be based on the factor (the index or the rate) as it changes over the life of the loan.

The definition of the interest method suggests that periodic interest cost is determined on the basis of a level effective rate (see Section 6.2.1). Because the interest cash flows of variable-rate debt vary in accordance with changes in a reference rate, however, the application of a constant discount rate to the remaining estimated cash flows could result in the recognition of significant gains and losses that do not reflect changes in the debt's outstanding amount. Therefore, it is not appropriate to recognize interest payments that vary on the basis of a reference interest rate by using an effective interest rate that is frozen at inception (although a frozen effective yield may be used to amortize a discount, a premium, or debt issuance costs, as discussed below).

If variable-rate debt has an associated discount or premium or debt issuance costs, an entity may amortize such amounts by using an amortization schedule that is fixed at inception on the basis of the reference rate that was in effect when the debt was first recognized. ASC 310-20 contains analogous guidance on the application of the interest method to the recognition of net fees and costs associated with the origination or acquisition of a loan asset that has a stated interest rate that varies on the basis of changes in an independent factor such as the prime rate. That guidance permits an entity to either freeze the effective interest rate at inception or continually update it as the factor changes over the loan's life as long as the method selected is applied consistently over the loan's life. ASC 310-20-35-18(c) and ASC 310-20-35-19 state, in part:

If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate [LIBOR], or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.

[The] lender may not change from one alternative to the other during the life of the loan. The lender must select one of the two alternatives and apply the method consistently throughout the life of the loan.

### 6.2.5.3 PIK Interest

**ASC Master Glossary**

**Payment-in-Kind Bonds**

Bonds in which the issuer has the option at each interest payment date of making interest payments in cash or in additional debt securities. Those additional debt securities are referred to as baby or bunny bonds. Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds (parent payment-in-kind bonds). Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.
Some debt instruments include a PIK interest feature that requires or permits interest to be satisfied through the issuance of an equivalent principal amount of additional debt instruments with the same terms as the original debt instrument. The following are two types of such PIK interest payment features:

- On each interest payment date, the issuer satisfies the interest payment obligation by issuing to the holder(s) additional debt instruments that have the same terms as the original debt instrument (i.e., additional fungible securities).

- On each interest payment date, the issuer increases the principal amount of the original debt instrument to reflect the interest accrued to the benefit of the holder. If the debt is convertible into equity shares, there is a proportionate increase in the number of such shares that will be issued upon exercise of the conversion feature. Economically, other than with respect to potential differences attributable to the compounding terms of an instrument, the PIK feature has the same effect as delivering additional debt instruments with the same terms as the original debt instrument.

Except for PIK features in convertible debt within the scope of the BCF guidance in ASC 470-20 (see Section 7.3.3 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt) and interest rate features that must be separated as derivatives under ASC 815 (see Section 8.4.6), the accounting literature does not directly address how to account for PIK features in debt instruments. For example, it does not provide guidance on:

- Whether and, if so, how to reflect PIK interest payments in the calculation of the effective interest rate of the original debt instrument.

- How to initially measure debt instruments issued (or accrued) as PIK interest.

For nonconvertible instruments, it is generally appropriate to analogize to the guidance on PIK features in convertible instruments subject to the BCF guidance in ASC 470-20. Under that guidance, the accounting for PIK features depends on whether the feature is discretionary or nondiscretionary. ASC 470-20-30-17 implies that an entity should consider a PIK feature in a nonconvertible debt instrument to be nondiscretionary if “neither the issuer nor the holder can elect other forms of payment for . . . interest.” Accordingly, a PIK feature would be considered discretionary if either the issuer or the holder can elect a form of payment other than PIK instruments (e.g., the issuer has the option to settle interest payment obligations by either delivering cash or issuing PIK instruments). A PIK feature would be considered nondiscretionary if interest payments must be paid in kind and neither party can elect another form of payment before the debt is repaid. (Entities need to consider additional factors when determining whether a convertible instrument should be viewed as discretionary or nondiscretionary; see Section 7.3.3 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt.)

In Discussion Document 3 (March 8, 2001), the EITF Issue 00-27 Working Group addressed the initial measurement of instruments issued (or accrued) under a PIK feature. It 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 . . . . 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. . . . 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.
The table below describes the accounting for PIK interest on nonconvertible debt instruments.

<table>
<thead>
<tr>
<th>Nondiscretionary PIK interest, and the debt does not contain any bifurcated derivative</th>
<th>Effective Interest Rate of the Original Debt Instrument</th>
<th>Initial Measurement of PIK Instruments Issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>The contractual cash flows of the PIK instruments that will be issued are incorporated into the computation of the effective interest rate of the original debt instrument. Unless some portion of interest must be paid in cash (e.g., 5 percent in cash and 5 percent in kind), an entity treats the original debt instrument as a zero-coupon instrument when applying the interest method.</td>
<td>When PIK interest is recognized, the debtor measures the PIK instruments issued at the present value of their contractual cash flows, discounted by using the effective interest rate of the original debt instrument.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Discretionary PIK interest, or the debt contains a bifurcated derivative</th>
<th>Effective Interest Rate of the Original Debt Instrument</th>
<th>Initial Measurement of PIK Instruments Issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>The effective interest rate of the original debt instrument may be computed on the basis of an assumption that the debtor will elect to pay interest in the form of cash. Alternatively, the debtor may assume that it will elect to pay interest in the form of either PIK instruments or cash, depending on which option is expected to be most economical (e.g., by considering the fair value of the PIK instruments in relation to the amount of cash interest that would be paid). If interest is expected to be paid in the form of PIK instruments, the fair value of those PIK instruments is incorporated into the computation of the effective interest rate of the original debt instrument as an assumed cash flow on each interest payment date.</td>
<td>When PIK interest is recognized, the debtor initially measures any debt instrument issued as PIK interest at its fair value as of its interest cost recognition date. If there is a difference between the cash flow assumed in the application of the interest method as of an interest payment date and the fair value of the PIK instrument issued, the debtor makes a corresponding adjustment to the amount of interest cost recognized. An entity should consider the frequency with which it recognizes accrued interest and the compounding terms of the debt, among other factors, to arrive at a reasonable and practical approach to recognizing the initial fair value of debt instruments issued as PIK interest. For example, an entity may determine that the contractual interest payment dates are the dates on which the fair value of PIK instruments should be measured.</td>
<td></td>
</tr>
</tbody>
</table>

**Example 6-14**

**Discretionary PIK Interest Feature — Interest May Be Paid in Cash or in Kind**

Company R issued debt securities with interest coupons that may be paid in cash or additional debt securities at R’s option. The original debt security pays interest at an 8 percent per annum rate. Company R elects the form of interest payments immediately before each payment date. This PIK feature is considered discretionary since R can choose the form of payment of the interest coupons. Therefore, the initial measurement amount of any PIK debt securities is their fair value on the interest cost accrual date.
**Example 6-15**

**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 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 debt securities is determined on the basis of the initial purchase price (i.e., A will deliver one-tenth of a debt security for each outstanding debt security). The debt securities 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 debt securities outstanding ($100,000 × 1.103).

This example presents a unique fact pattern in which the PIK interest payments could be considered to contain both a discretionary and nondiscretionary element. Debt securities issued after March 31, 20X3, should be initially measured as discretionary PIK instruments at their fair value as of the interest accrual dates. However, debt securities issued during the first three years may be treated as nondiscretionary PIK instruments. That is, A would treat the original instrument as paying no interest during years 1–3 and, when applying the interest method, would assume that the PIK instruments that will be issued during those years are instead paid in cash at the end of the original instrument's life.

**6.2.5.4 Loss Contingencies**

<table>
<thead>
<tr>
<th>ASC 450-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-2</strong> An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:</td>
</tr>
<tr>
<td>a. Information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that it is probable that . . . a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.</td>
</tr>
<tr>
<td>b. The amount of loss can be reasonably estimated.</td>
</tr>
<tr>
<td>The purpose of those conditions is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. . . . As discussed in paragraph 450-20-5-5, disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Further, even losses that are reasonably estimable shall not be accrued if it is not probable that an asset has been impaired or a liability has been incurred at the date of an entity's financial statements because those losses relate to a future period rather than the current or a prior period. Attribution of a loss to events or activities of the current or prior periods is an element of . . . liability incurrence.</td>
</tr>
</tbody>
</table>

Sometimes, debt instruments require the issuer to make one or more payments upon the occurrence or nonoccurrence of specified events. For example, a debt instrument might require the debtor to pay a fixed amount on the basis of a condition linked to the issuer's creditworthiness. If no other accounting literature applies (e.g., the provision does not need to be separated as a derivative under ASC 815-15 and is not subject to the indexed-debt guidance in ASC 470-10), the issuer should evaluate whether it must accrue a probable loss under the loss contingency guidance in ASC 450-20. Under that guidance, an expense must be accrued if it is probable that a payment will be required and the amount of the payment can be reasonably estimated (see Deloitte’s *A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees*). Note, however, that if the payment varies on the basis of a price or an index (e.g., it varies on the basis of a measure of inflation) and no other accounting literature applies, the debtor should generally apply the guidance on indexed debt in ASC 470-10 (see Section 7.4) instead of the loss contingency guidance in ASC 450-20.
Example 6-16

Contingent Payment on Debt Instrument

Entity A has issued 10-year notes that include a provision that requires A to maintain a leverage ratio of 8:1 or lower as of each quarterly reporting date. The leverage ratio is expressed as A’s total consolidated indebtedness as of the date of determination to its most recently reported annualized EBITDA. If A fails to maintain the specified leverage ratio, the notes become immediately due and payable unless A makes a cash payment of $20 million to the notes’ holders. Entity A has determined that it is not required to separate the contingent penalty provision as an embedded derivative. In this circumstance, the contingent payment represents a loss contingency that should be evaluated under ASC 450-20-25-2. If it becomes probable that A will be required to make the payment, A should record an immediate charge to earnings for the amount of the loss.

6.2.5.5 Gain Contingencies

ASC 450-30

25-1 A contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization.

Sometimes, debt instruments include contractual terms under which some or all of the principal or interest payments will be forgiven upon the occurrence or nonoccurrence of specified events. For example, some debt securities include bail-in provisions under which a regulatory authority has the power to write down or cancel the debt. In the absence of the occurrence or nonoccurrence of the specified events, however, the full stated amount of principal and interest is payable. If no other accounting literature applies (e.g., the provision does not need to be separated as a derivative under ASC 815-15), it is generally not appropriate for the issuer to anticipate that some or all of its obligation might be cancelled in the future. Such an expectation is akin to a contingent gain that should be recognized only if or when the gain is realized or realizable under the guidance on gain contingencies in ASC 450-30 (see Chapter 3 of Deloitte’s A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees). Further, under ASC 405-20, a debtor generally is not permitted to derecognize a debt obligation before it has been extinguished (see Section 9.2).

Connecting the Dots

There is no guidance in U.S. GAAP that specifically addresses whether an entity is permitted to account for a forgivable loan from a government entity as an in-substance government grant. However, in all situations in which a debtor expects to repay a forgivable loan, it must account for that amount as debt.

6.2.5.6 Actual or Expected Payment Defaults

Under the interest method, a debtor accrues interest on the basis of the amounts that are contractually due even if the debtor is unable, or expects to be unable, to pay some or all of those amounts. In the absence of a debt modification or exchange that qualifies as a debt extinguishment (see Chapter 10) or TDR (see Chapter 11), it is not appropriate for a debtor to adjust or write off debt discounts, premiums, or debt issuance costs even if it has defaulted or is expected to default or violate covenants of the underlying debt. Further, an entity is not permitted to anticipate that the creditor will forgive some or all of the outstanding amount of principal and interest in the future. The expectation of full or partial forgiveness is akin to a contingent gain that should be given accounting recognition only if or when the gain is realized or realizable under the guidance on gain contingencies in ASC 450-30 (see Section 6.2.5.5 above). Further, in accordance with ASC 405-20, a debtor generally is not permitted to derecognize a debt obligation before it has been extinguished (see Section 9.2).
However, an adjustment to the debt’s net carrying amount and the related amounts of any debt discount, premium, or debt issuance costs may become necessary if the debtor is subject to reorganization proceedings under the U.S. Bankruptcy Code. ASC 852-10-45-6 states:

Debt discounts or premiums as well as debt issue costs shall be viewed as valuations of the related debt. When the debt has become an allowed claim and the allowed claim differs from the net carrying amount of the debt, the recorded amount shall be adjusted to the amount of the allowed claim (thereby adjusting existing discounts or premiums, and deferred issue costs to the extent necessary to report the debt at this allowed amount). The gain or loss resulting from the entries to record the adjustment shall be classified as reorganization items, as discussed in paragraph 852-10-45-9. Premiums and discounts as well as debt issuance cost on debts that are not subject to compromise, such as fully secured claims, shall not be adjusted.

If the recorded amount is adjusted under ASC 852, discounts, premiums, and issuance costs should continue to be amortized over the life of the debt that was assumed when the obligation was originally recorded.

### 6.2.5.7 Nonrecourse Beneficial Interests

#### 6.2.5.7.1 Background

For nonrecourse beneficial interest liabilities (i.e., obligations indexed to a pool of financial assets) for which both fixed and contingent payments are required, special methods of recognizing interest expense may be acceptable if (1) the contingent payment obligation is not subject to derivative accounting under ASC 815 (see Chapter 8) and (2) the issuer has not elected the fair value option for the instrument under ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4). Such special methods include:

- The expected-effective-yield method (see Section 6.2.5.7.2)
- The hypothetical liquidation at fair value (HLFV) method (see Section 6.2.5.7.3).

#### 6.2.5.7.2 Expected-Effective-Yield Method

Under the expected-effective-yield method, the debtor recognizes interest expense in each reporting period by using an effective interest rate that is determined on the basis of expected cash flows over the life of the debt.

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**Example 6-17**

**Liability Secured by Receivables**

Entity A obtains a five-year loan from Bank B. The loan has a fixed, stated interest rate of 12 percent and is collateralized by a pool of revolving credit card receivables that A holds. When A receives payments from the underlying receivables, it is required under the terms of the loan to use a specified portion of those cash flows to pay the fixed interest and repay a portion of the principal amount to B on the basis of a waterfall schedule. If the projected cash flows from the underlying receivables at any time are insufficient to repay the principal amount and to pay the fixed interest to B, A is required to fund the deficit by using other assets. Further, B is entitled to participate in any residual cash flows generated by the pool once A has made its required principal and fixed interest payments. Because this participation is contingent on the performance of the receivables, it represents a contingent payment obligation of A. At inception of the loan, there is an expectation that contingent payments will be payable to B.

We believe that in this scenario, A may apply either (1) a contingent interest expense recognition model that is similar to the guidance on indexed debt instruments (see Section 7.4) or on participating mortgages (see Section 7.3), such as the HLFV method (see Section 6.2.5.7.3), or (2) an effective-yield interest expense recognition approach on the basis of the effective interest rate expected to be paid over the life of the loan by analogy to the method that may be elected for anticipated prepayments on a large number of similar loans under ASC 310-20-35-26 through 35-33.
Example 6-17 (continued)

If A elects to apply an effective-yield interest expense recognition approach, it should reflect in its determination of the effective interest rate the amount and timing of all cash flows expected to be paid on the loan, which would be affected by the expected performance of the pool of receivables. However, A cannot anticipate nonpayment of the principal amount or the fixed-interest cash flows because those payments are contractual. Although those amounts must be paid even if the cash flows from the pool of receivables are insufficient, this conclusion would not change if this were not the case.

If the expected timing or amount of the cash flows change, A applies a retrospective interest method (see ASC 310-20-35-26). That is, it recalculates the effective interest rate by determining the effective interest rate that would have existed when the debt was first recognized on the basis of the original net carrying amount, actual payments to date, and the revised estimate of remaining future payments. Entity A then adjusts the debt's current net carrying amount to an amount equal to the present value of the estimated remaining future payments, discounted by using the revised effective interest rate, with an offsetting adjustment to interest expense.

6.2.5.7.3 HLFV Method

An entity uses the HLFV method to measure interest expense for a nonrecourse beneficial interest liability (i.e., an obligation indexed to a pool of financial assets) as of each reporting date on the basis of an assumption that the pool was liquidated, the assets held were sold at fair value, and the proceeds on sale were distributed in accordance with the waterfall provisions that govern the distribution of the cash flows generated by the pool of assets.

Example 6-18

Nonrecourse Beneficial Interest Liability

Entity E consolidates Trust T, which is a collateralized loan obligation (CLO) entity. Trust T holds investments in variable-rate debt instruments that pay interest at three-month LIBOR and meet certain other criteria. In addition, T has issued three classes of 10-year nonrecourse beneficial interests in the assets it holds:

- **Class A notes** — The principal amount of such notes is $500 million, they are the most senior interests issued by T, and they have a first-priority security interest in each asset T holds. The class A notes accrue interest at three-month LIBOR plus 50 basis points per annum, payable quarterly. No distributions of excess cash flows received on the assets held may be paid on the other notes issued by T until all principal and interest on the class A notes have been paid in full. If an event of default occurs (e.g., T fails to pay any required principal or interest payments on the class A notes when due), holders of a majority of the notes have the right to declare them immediately due and payable.

- **Class B notes** — The principal amount of such notes is $50 million and they have a subordinated priority security interest in each asset held by T. Available cash flows received from the assets held by T are paid quarterly on the class B notes until a 15 percent annual internal rate of return is achieved. Trust T’s inability to make payments to holders of the class B notes does not constitute an event of default. At T’s inception, there was an expectation that the class B notes would achieve at least a 15 percent return.

- **Income notes** — The principal amount of such notes is $25 million, they are the most subordinated beneficial interests issued by T, and they have no stated interest rate. The inability of T to make payments to holders of the income notes does not constitute an event of default. The income notes are held by E.
Example 6-18 (continued)

If certain coverage tests are met, any excess cash flows received on the assets held by T after required principal and interest payments have been made on the class A notes and class B notes are distributed quarterly to holders of the class B notes and income notes on a 50:50 basis. Under the coverage tests, (1) the class A notes’ overcollateralization ratio (i.e., the ratio of the aggregate principal amount of debt instruments held by T to the aggregate principal amount of class A notes) must exceed 105 percent and (2) the class A notes’ interest coverage ratio (i.e., the ratio of the interest proceeds received on the assets held by T [net of expenses and fees] to the accrued and unpaid interest on the class A notes) must exceed 115 percent on the applicable quarterly payment date before distributions of excess cash flows can be made to holders of class B notes and income notes. If the coverage tests are not met on a quarterly payment date, any excess cash flows are used to pay down the principal amount of the class A notes.

Entity E has determined that the beneficial interests issued do not contain any features that must be accounted for separately as derivatives (see Chapter 8). Further, E has not elected to apply the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4) to the beneficial interests.

There are two interest elements related to the class B notes: (1) interest up to a 15 percent annual internal rate of return and (2) excess interest determined on the basis of the excess cash flows on the assets held by T.

Irrespective of T’s performance (e.g., the level of credit losses), E should recognize interest expense on the class B notes on the basis of a 15 percent effective yield. Although the class B notes may not receive interest equal to a 15 percent annual return if certain levels of credit or other losses occur, the class B notes have a stated interest rate of 15 percent. In substance, the stipulated interest rate on the class B notes is similar to the stipulated interest rate on the class A notes because both are nonrecourse debt obligations that will receive the stated return only if the assets held by T generate sufficient cash flows. Further, it would be inappropriate for E to reduce the carrying amount of the class B notes below the unpaid principal amount plus accrued and unpaid interest at a 15 percent annual internal rate of return because the extinguishment criteria in ASC 405-20-40-1 (see Section 9.2) are not met (i.e., T is not legally released from its role as primary obligor under the class B notes until the principal amount and accrued and unpaid interest is repaid in full or T liquidates.

Because the excess interest that will be paid on the class B notes is contingent on the performance of T’s assets, it would be appropriate for E to apply the contingent payment obligation guidance related to indexed-debt instruments in ASC 470-10 (see Section 7.4) or participating mortgages in ASC 470-30 (see Section 7.3). In the calculation of the amount of excess interest expense under this guidance, it would be acceptable for E to apply the hypothetical liquidation at book value method (as described in ASC 323-10-55-54 through 55-57), except that the fair value of the assets held by T should be used in the hypothetical liquidation analysis (i.e., the HLFV method).

Under the HLFV method, as of each financial reporting date, excess interest expense on the class B notes is measured on the basis of the assumption that T was liquidated, the assets held were sold at fair value, and the proceeds on sale were distributed in accordance with the terms of the beneficial interests. This method has the effect of recognizing excess interest expense on the class B notes on the basis of the “applicable index” (the fair value of T’s assets) in accordance with the guidance on indexed-debt instruments in ASC 470-10 (see Section 7.4).

At the end of the first annual reporting period, the aggregate fair value of the assets held by T is $600 million and three-month LIBOR is 2.0 percent. If these assets were to be sold at fair value, $512 million would be allocated to the class A notes (which includes the repayment of principal of $500 million and the payment of $12 million of interest). Further, $57.5 million would be allocated to the class B notes (which includes the repayment of principal of $50 million and $7.5 million of interest at 15 percent). After these distributions, $30.5 million would remain. Fifty percent of this residual cash flow ($15.25 million) would be allocated to the class B notes as additional interest. As a result, at the end of the reporting period, E should recognize total interest expense on the class B notes of $22.75 million.
Example 6-18 (continued)

When applying the HLFV method in subsequent financial reporting periods, E should recognize excess interest expense amounts on the basis of the excess of (1) the cumulative amounts that would be paid to the class B notes (which consist of (a) the 15 percent annual yield, (b) the amount of excess interest above the 15 percent yield that has been previously paid in cash, and (c) the excess interest that results from the current-period application of the HLFV method) over (2) the total interest expense recognized in prior periods. This could involve the reversal of previously recognized excess interest, but in no circumstance should the total interest expense recognized, on a cumulative basis, be less than a 15 percent effective yield on the principal amounts outstanding, plus the amount of any excess interest above the 15 percent yield that has been previously paid in cash. Therefore, the total carrying amount related to the class B notes will always equal the excess of (1) the initial principal amount invested ($50 million), plus interest accrued at a 15 percent annual effective yield on the unpaid principal amount, plus excess interest accrued over (2) principal and interest amounts paid on the class B notes.

Also, the determination of whether cash distributions are (would be) reflected as repayments of principal or as a return (and the associated impact such decision has on the calculation of the 15 percent annual yield) should be consistent with the contractual terms of the beneficial interests. Reflecting payments as a reduction of principal in accordance with such terms is consistent with the legal extinguishment concept in ASC 405-20-40-1 (see Section 9.2) as long as under the terms, interest no longer accrues at a 15 percent annual yield for amounts that are considered principal repayments.

If the cumulative cash interest paid on the class B notes exceeds the amount of interest expense recognized in accordance with the application of the accounting guidance described above, the excess amounts paid would not be reflected as interest expense. Rather, provided that the conditions for offsetting in ASC 210-20-45-1 are not met or are not applied (see Section 14.3.1.1), the excess interest would be reported by E as prepaid interest.

6.3 Fair Value Option

6.3.1 Background

ASC 825-10

45-4 A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date.

45-5 If an entity has designated a financial liability under the fair value option in accordance with this Subtopic or Subtopic 815-15 on embedded derivatives, the entity shall measure the financial liability at fair value with qualifying changes in fair value recognized in net income. The entity shall present separately in other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk. The entity may consider the portion of the total change in fair value that excludes the amount resulting from a change in a base market risk, such as a risk-free rate or a benchmark interest rate, to be the result of a change in instrument-specific credit risk. Alternatively, an entity may use another method that it considers to faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. The entity shall apply the method consistently to each financial liability from period to period.
As discussed in Section 4.4, entities can elect a fair value option to account for certain financial assets and financial liabilities at fair value. ASC 825-10-45-4 states that the changes in fair value of an item for which the fair value option is elected should be recognized in net income (or another performance indicator if an entity does not report net income). However, this does not apply to the recognition of all of the change in the fair value of a financial liability for which the fair value option has been elected. The change must be presented in other comprehensive income (OCI) to the extent that it is attributable to instrument-specific credit risk (see Section 6.3.2 below). The remaining portion of the change in fair value is recognized in net income. Upon derecognition of the financial liability, any amounts accumulated in OCI are recognized in net income (see Section 9.3.2). Special considerations are necessary if an entity is required or elects to separately present interest expense on debt for which it has elected the fair value option (see Section 6.3.3).

6.3.2 Presentation Guidance for Instrument-Specific Credit Risk

6.3.2.1 Measuring Instrument-Specific Credit Risk

The change in fair value attributable to a financial liability for which the fair value option is elected must be presented in OCI to the extent that it is attributable to instrument-specific credit risk. The change in fair value attributable to instrument-specific credit risk represents the component of the change in fair value of the financial instrument attributable to changes in the specific credit risk of that instrument (e.g., changes in “credit spread” associated with the instrument). As noted in ASC 825-10-45-5, one acceptable method of isolating the change attributable to instrument-specific credit risk is to calculate (1) the hypothetical change in fair value of the instrument during the period that is attributable to changes in the risk-free or benchmark rate and (2) the difference between that amount and the total change in fair value. (This method of computing the component of the total change in fair value that is attributable to instrument-specific credit risk is illustrated in paragraphs B5.7.18 and IE1–IE5 of IFRS 9.) Alternatively, an entity may use another method that it considers to faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk. However, the entity must apply that method consistently to each financial instrument from period to period.

Example 6-19

Calculation of Instrument-Specific Credit Risk

On January 1, 20X8, Company A issues an uncollateralized five-year bond with a par value and fair value of $500 million and an interest rate of 8 percent and elects to record the bond at fair value in accordance with ASC 825. Assume the following:

- Interest is paid annually; the bond has a bullet maturity.
- Three-month LIBOR, a benchmark rate, was 5 percent on January 1, 20X8. As of March 31, 20X8, three-month LIBOR has increased to 5.5 percent.
- The change in three-month LIBOR is the only relevant change in general market conditions.
- The fair value of the bond as of March 31, 20X8, is $495 million, which indicates a market rate of interest on the bond of 8.3 percent.
- Company A computes the change in fair value that is attributable to instrument-specific credit risk by calculating the portion of the total change in fair value of the instrument during the period that is not attributable to changes in general market conditions. As discussed above, entities are not required to use this method to calculate the change in fair value attributable to instrument-specific credit risk.
- For simplicity, it is assumed that (1) there is a flat yield curve, (2) all changes in interest rates result from a parallel shift in the yield curve, and (3) the changes in three-month LIBOR are the only relevant changes in general market conditions. An entity should base its calculations on actual market conditions.
Example 6-19 (continued)

The market rate of interest upon the bond's issuance was 8 percent. The components of the market rate include (1) the benchmark rate (three-month LIBOR) of 5 percent, and (2) 3 percent, which represents the bond's credit risk or “credit spread.” At the end of the period, three-month LIBOR increases to 5.5 percent and there are no other changes in general market conditions that would affect the valuation of the bond.

To determine the change in fair value of the bond associated with instrument-specific credit risk, A calculates the present value of the remaining contractual cash flows by using an 8.5 percent rate consisting of the benchmark interest rate at the end of the period (5.5 percent) and the initial spread from the benchmark rate upon issuance of the bond (3 percent). The resulting present value of the remaining cash flows, discounted at 8.5 percent, is $492 million.

The fair value of the bond as of March 31, 20X8, is $495 million. Thus, the portion of the change in fair value of the bond associated with instrument-specific credit risk during the period is $3 million. In other words, the fair value of the bond decreased by $8 million because of a change in general market conditions (the increase in LIBOR) and increased by $3 million because of the narrowing of the credit spread on the bond. Thus, in accordance with ASC 825-10-45-5, in preparing its financial statements and recognizing the bond at fair value, A would reduce the carrying amount of the bond by $5 million and would recognize a loss in earnings of $8 million and a gain in OCI of $3 million. Note that A is also required to determine instrument-specific credit risk for disclosure purposes.

In the absence of other changes in general market conditions, the change in fair value that is attributable to instrument-specific credit risk in the next period would be based on a comparison of the fair value of the bond at the end of the period, with the present value of future cash flows discounted at three-month LIBOR at the end of the period, added to an instrument-specific credit spread of 2.8 percent (8.3% – 5.5%). The 8.3 percent represents the implicit market yield on the bond at the end of the previous period (i.e., the effective yield of the bond, which is based on discounting the remaining cash flows and a fair value of $495 million at the beginning of the period). To determine the credit spread at the end of the previous period, A subtracts the 5.5 percent (the benchmark rate at the end of the previous period).

6.3.2.2 Foreign-Currency-Denominated Liabilities

ASC 825-10

45-5A When changes in instrument-specific credit risk are presented separately from other changes in fair value of a liability denominated in a currency other than an entity's functional currency, the component of the change in fair value of the liability resulting from changes in instrument-specific credit risk shall first be measured in the liability's currency of denomination, and then the cumulative amount shall be adjusted to reflect the current exchange rate in accordance with paragraph 830-20-35-2. The remeasurement of the component of the change in fair value of the liability resulting from the cumulative changes in instrument-specific credit risk shall be presented in accumulated other comprehensive income.

ASC 830-20

35-7A Paragraph 825-10-45-5A requires that for a financial liability for which the fair value option is elected, the change in the liability's fair value resulting from changes in instrument-specific credit risk shall be presented separately in other comprehensive income from other changes in the liability's fair value presented in current earnings. The component of the change in fair value of the liability resulting from changes in instrument-specific credit risk shall first be measured in the liability's currency of denomination, and then the cumulative amount shall be adjusted to reflect the current exchange rate in accordance with paragraph 830-20-35-2. The remeasurement of the component of the change in fair value of the liability resulting from the cumulative changes in instrument-specific credit risk shall be presented in accumulated other comprehensive income.
ASC 825-10-45-5A and ASC 830-20-35-7A provide guidance on the measurement of the instrument-specific credit risk component of a foreign-denominated financial liability. In accordance with that guidance, entities are required to apply the following two-step measurement approach:

- Measure the instrument-specific credit risk component of the change in fair value of the liability in the liability's currency of denomination.
- Adjust the cumulative amount of changes in instrument-specific credit risk in the currency of denomination of the liability to the entity's functional currency by using the exchange rate as of the measurement date (i.e., the balance sheet date).

### 6.3.2.3 Nonrecourse Financial Liabilities

The guidance in ASC 825-10-45-5 and 45-5A that requires separate presentation in OCI of the portion of the change in fair value of a financial liability that is attributable to instrument-specific credit risk does not apply to liabilities that do not contain instrument-specific credit risk. A liability that is nonrecourse to the issuer does not contain instrument-specific credit risk. Therefore, changes in fair value associated with a nonrecourse financial liability designated under the fair value option should be recognized entirely in earnings. This view was discussed with the FASB staff, which agreed with the conclusion reached.

It is important for an entity to differentiate between instrument-specific credit risk and asset-specific performance risk when assessing a financial liability whose amounts are payable only upon receipt of cash flows from specified assets (e.g., securitization structures). This distinction is important because in some circumstances, a financial liability may have little or no instrument-specific credit risk and substantially all the changes in the fair value of the liability may be attributable to asset-specific performance risk. In such cases, when the borrower does not have any obligation to make a payment if the assets to which the obligation is contractually linked fail to perform, changes in the fair value of the liability would be recognized in earnings. For example, an entity that issues a note whose cash flows are contractually linked to an underlying pool of financial assets (e.g., loans, corporate bonds) would have no obligation to make payments unless amounts are received on the underlying pool of assets. In such circumstances, all changes in fair value would be recognized in earnings.

Depending on how the obligation is structured, there may still be some instrument-specific credit risk when there is also asset-specific performance risk. For example, if amounts received on the underlying pool of assets are not immediately payable to the lender (i.e., there is a timing difference between the receipt of cash flows from the assets and the payment on the obligation), the borrower will owe amounts to the lender even when the assets have performed. Depending on whether the borrower is able to use the cash received on the assets for purposes other than to pay its obligation under the financial liability, there may be some residual instrument-specific credit risk, which may sometimes be minimal.

### 6.3.3 Presentation of Interest Expense

An entity is not required to separately present, in its income statement, interest expense for debt accounted for at fair value through earnings unless (1) the entity must do so in accordance with regulatory guidance or (2) it is industry practice to do so (for example, bank holding companies, brokers and dealers in securities, and investment companies generally present interest separately from other changes in fair value in their income statements). However, the entity may elect, as an accounting policy, to present interest expense separately from other changes in the fair value of financial instruments measured at fair value through earnings. This election would apply to interest-bearing financial liabilities that are measured at fair value through earnings under the fair value option in ASC 825 or ASC 815, as
well as those interest-bearing liabilities that are measured at fair value under other relevant GAAP. If an entity's elected accounting policy related to separate recognition of interest expense is considered significant, the entity should disclose that policy in accordance with ASC 235-10-50-1.

If an entity elects, as an accounting policy, to separately present interest expense on an interest-bearing financial liability accounted for at fair value through earnings, the entity should, with one exception discussed below, include amortization or accretion of any premium or discount on the instrument as part of the separately reported interest expense. If the fair value initially recognized for an interest-bearing financial liability (e.g., debt) differs from the principal amount due at maturity, this difference is a premium or discount that should be amortized or accreted. An entity should recognize the amortization or accretion in interest expense if it is separately presented. The premium or discount should be amortized by using the interest method that would have applied to the interest-bearing financial liability if it had not been recognized at fair value through earnings (see Section 6.2).

The guidance above does not apply to the following:

- The portion of the difference between fair value and par at inception attributable to embedded features that are not indexed to interest rates or the issuer's own credit (e.g., an in-the-money option that permits the holder to convert the debt instrument into a fixed number of the issuer's equity shares). Entities should exclude such features from the discount or premium to be accreted or amortized.

- Any transaction costs and fees, such as debt issuance costs, origination costs, and origination fees (i.e., up-front costs and fees) are not part of the initial measurement of a financial instrument that is recognized at fair value and therefore are not included in any premium or discount of the financial instrument in accordance with ASC 825-10-25-3. That is, the interest method is used only for applicable discounts and premiums since up-front costs and fees are recognized in earnings as they are incurred or received (see Section 5.5 for discussion of the initial recognition of up-front costs).
Chapter 7 — Special Accounting Models for Certain Types of Debt

7.1 Background
This chapter discusses the specialized accounting models that apply to the following types of debt:

- Sales of future revenues (see Section 7.2 below).
- Participating mortgages (see Section 7.3).
- Indexed debt (see Section 7.4).
- Joint-and-several liability arrangements (see Section 7.5).
- Convertible debt (see Section 7.6).
- Debt exchangeable into the stock of another entity (see Section 7.7).

7.2 Sales of Future Revenues

7.2.1 Background
A seller of future revenue should evaluate whether the proceeds received should be accounted for as debt or deferred income under ASC 470-10. Sales of future revenue that are accounted for as debt are subject to the interest method, as further discussed below.

7.2.2 Scope

<table>
<thead>
<tr>
<th>ASC 470-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-1 An entity receives cash from an investor and agrees to pay to the investor for a defined period a specified percentage or amount of the revenue or of a measure of income (for example, gross margin, operating income, or pretax income) of a particular product line, business segment, trademark, patent, or contractual right. It is assumed that immediate income recognition is not appropriate due to the facts and circumstances. The payment to the investor and the future revenue or income on which the payment is based may be denominated in a foreign currency.</td>
</tr>
</tbody>
</table>

In a sale of future revenue (such as a profit-sharing agreement, a securitization of a participation in a future revenue stream, a celebrity bond, or other contingent payment obligation that varies on the basis of future revenue or income), an entity receives an up-front lump sum payment from an investor and, in return, agrees to pass on a specified percentage or amount of its future revenue or income to that investor for a specified period. The share of revenue or income owed to the investor may be graduated (e.g., 50 percent of the first $1 million of revenue and then 25 percent of the amount in excess of $1 million) or may be different from year to year. Further, the entity might guarantee a minimum amount to be paid to the investor or there may be a maximum total amount payable. The underlying cash flows that the entity will pass on might originate from its contractual arrangements with third parties (e.g., fees
and royalties that it will receive from the licensing of patents, copyrights, trademarks, or technology and franchise agreements) or its operations (e.g., a specified interest in revenue, gross margin, or income of the entity or one of its subsidiaries, business segments, or product lines).

**Example 7-1**

**Sale of Royalty Income**

Company C makes an up-front payment of $60 million to Company D in exchange for the right to collect five years of future royalties from specified songs covered by intellectual property rights owned by D.

**Example 7-2**

**Sale of Patent Infringement Litigation Claims**

Company L enters into a patent litigation funding agreement with Company Y. Company Y is engaged in the business of investing in commercial legal claims it believes to be meritorious. Under the agreement, Y agrees to pay up to $20 million of the litigation costs that will be incurred by L to pursue claims against defendants that may be infringing on L’s patents. In exchange, L assigns to Y the rights to an amount of awards, damages, royalties, settlements, judgments, and any other consideration received in connection with a settlement or award in a judgment equal to 100 percent of Y’s invested amount plus a fixed percentage of consideration received in excess of 100 percent of Y’s invested amount.

**Example 7-3**

**Sale of Net Income**

Company E enters into an agreement with Company P under which P makes an up-front cash payment of $10 million in exchange for a right to 40 percent of E's net profits from the operation of a hotel for 72 calendar months. Company E is responsible for the management of the financial affairs of the hotel, including the payment of all expenses of construction, opening, operating, furnishing, supplying, marketing, maintaining, and repairing the hotel. Company P does not have any operational responsibilities or rights related to the hotel. Further, the arrangement does not create a partnership or joint venture between the parties. Company E has the right to terminate the agreement at any time, provided that it pays P a termination fee in an amount equal to the net present value of the expected net profits from the date of the termination until the end of the term of the agreement.

Typically, an entity is not required to account for a contract for the sale of future revenues as a derivative instrument because ASC 815-10-15-59(d) contains a scope exception for non-exchange-traded contracts for which the settlement is based on a specified volume of sales or service revenues of one of the parties to the contract (see Section 8.4.10). A FASB staff publication, The Impact of the Issuance of Statement 133 on Then-Existing Consensuses for EITF Issues (November 13, 2000), states, in part:

`Generally, the contracts to pay a portion of revenue received and other amounts as described in [ASC 470-10-25-1] would not be subject to the requirements of [ASC 815] because any related derivative (or embedded derivative) would meet the exception in [ASC 815-10-15-59(d)] related to involving an underlying based on specified amounts of sales or service revenues by one of the parties to the contract.`

Sales of future revenues that are addressed by ASC 470-10 represent transactions that are not within the scope of the guidance in ASC 860-10 on transfers of financial assets. ASC 860-10 only applies to transfers of recognized financial assets. ASC 860-10-20 defines a financial asset as follows:

- Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:
  - a. Receive cash or another financial instrument from a second entity
  - b. Exchange other financial instruments on potentially favorable terms with the second entity.
At the 1997 AICPA Conference on Current SEC Developments, SEC Professional Accounting Fellow Armando Pimentel noted that the SEC staff “has applied this definition very strictly” (i.e., narrowly). Accordingly, a seller of a right that entitles the holder to a share of receivables that have not yet been recognized for accounting purposes (e.g., receivables that will be recognized in the future related to existing or anticipated orders for the entity’s goods or services) would apply the guidance on sales of future revenue in ASC 470-10 instead of the guidance on transfers of financial assets in ASC 860-20. (See Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard for further discussion of the point in time at which a receivable should be recorded under a contract with a customer in accordance with ASC 606.)

A contract to service a financial asset (i.e., a servicing right) entitles the holder to a stream of future revenue associated with a financial asset, but that contract is not a financial asset because it depends on the delivery of future services. The accounting for a transfer of servicing rights is addressed in ASC 860-50-40.

7.2.3 Classification

7.2.3.1 Background

<table>
<thead>
<tr>
<th>ASC 470-10</th>
</tr>
</thead>
</table>

25-2 While the classification of the proceeds from the investor as debt or deferred income depends on the specific facts and circumstances of the transaction, the presence of any one of the following factors independently creates a rebuttable presumption that classification of the proceeds as debt is appropriate:

- a. The transaction does not purport to be a sale (that is, the form of the transaction is debt).
- b. The entity has significant continuing involvement in the generation of the cash flows due the investor (for example, active involvement in the generation of the operating revenues of a product line, subsidiary, or business segment).
- c. The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity.
- d. The investor's rate of return is implicitly or explicitly limited by the terms of the transaction.
- e. Variations in the entity's revenue or income underlying the transaction have only a trifling impact on the investor's rate of return.
- f. The investor has any recourse to the entity relating to the payments due the investor.

ASC 470-10 requires a seller of future revenue to evaluate whether the offsetting entry to the proceeds received should be classified as debt or deferred income. It is generally inappropriate to record the proceeds immediately as income, because the seller maintains some continuing involvement and the earnings process is not completed when the cash is received.

Further, the proceeds cannot be recorded to equity unless the contract legally represents an ownership interest in an entity that is not required to be classified as a liability under GAAP (e.g., under ASC 480; see Deloitte’s A Roadmap to Distinguishing Liabilities From Equity).

ASC 470-10-25-2 requires an entity to consider six factors in determining the appropriate classification of the proceeds:
Factors That Create Rebuttable Presumption of Debt | Factors That Could Help Overcome the Debt Presumption
---|---
“[T]he form of the transaction is debt” (see Section 7.2.3.2) | The transaction purports to be a sale
“The entity has significant continuing involvement in the generation of the cash flows due to the investor” (see Section 7.2.3.3) | The entity is not significantly involved in the generation of the cash flows owed to the investors
“The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity” (see Section 7.2.3.4) | The agreement is not cancelable
“The investor’s rate of return is implicitly or explicitly limited by the terms of the transaction” (see Section 7.2.3.5) | There is no cap on payments to the investor
“Variations in the entity’s revenue or income underlying the transaction have only a trifling impact on the investor’s rate of return” (see Section 7.2.3.6) | Variations in the level of revenue or income can produce at least moderate variations in the investor’s return
“The investor has any recourse to the entity relating to the payments due the investor” (see Section 7.2.3.7) | The agreement includes no guarantees, recourse, or collateral provisions

If any of the six factors in ASC 470-10-25-2 are present, there is a rebuttable presumption that the proceeds should be classified as debt. Accounting for the proceeds from the sale of future revenue as debt highlights that the proceeds received will be repaid in cash, not in goods or services. Such accounting is appropriate when the transaction is in the form of debt or any of the factors in ASC 470-10-25-2 are present.

The presumption that the proceeds should be classified as debt can be overcome, and the proceeds may be accounted for as deferred income, if the transaction purports to be a sale and none of factors in ASC 470-10-25-2 are present. Such accounting suggests that the entity has accelerated the collection of cash from the sales of goods or services in a manner similar to a nonrefundable advance payment received from a customer.

**Example 7-4**

**Sale of Future Revenue Accounted for as Debt**

On March 31, 20X0, Entity A enters into an agreement with Entity B under which A agrees to sell $250 million of future receivables associated with its anticipated sales of a specified product in exchange for a $175 million up-front cash payment. Entity A continues to be solely responsible for research and development, regulatory compliance, intellectual property protection, manufacturing, marketing, distribution, sales, product liability, and reimbursement associated with the product. Under the agreement, A is required to make quarterly payments for five years. Quarterly repayment amounts are subject to both a fixed cap of $25 million each quarter and a variable cap equal to 10 percent of quarterly revenues. Any amounts that remain outstanding after five years are to be paid in subsequent quarters subject to the 10 percent of quarterly revenues cap. Entity A has an option to prepay its obligation at an amount equal to $250 million less amounts already paid at the time of prepayment. Entity B has a security interest in A’s rights related to the product and will have a secured interest in the future receivables once they come into existence. Entity A concludes that the transaction should be accounted for as debt under ASC 470-10 because the factors in ASC 470-10-25-2(b)-(f) are present. Entity A treats the proceeds of $175 million as the principal amount of the debt. The additional $75 million that will be repaid is recognized as interest over the life of the debt.
7.2.3.2 Legal Form of Debt

A sale of future revenue may have the legal form of a nonrecourse borrowing. If the transaction's legal form is that of debt (e.g., a securitization of future revenue), the issuer should classify the transaction as debt. Accounting for the transaction as deferred revenue would be inappropriate since the form of a transaction that is legally debt is respected under U.S. GAAP.

Even if the legal form of a transaction is not that of debt, it may have debt-like characteristics that suggest that it should be accounted for as debt. Such characteristics may include the following:

- The proceeds must be used for a specific purpose (e.g., the purchase of equipment).
- There are covenants restricting the entity's level of indebtedness until the initial amount received is repaid.
- The contract has a predefined prepayment schedule (e.g., periodic repayments and a final repayment).
- There is a contractual interest charge.
- The entity pledges its assets as collateral to ensure the repayment of the proceeds received.
- Any portion of the proceeds received that remain unpaid becomes immediately due and payable on a specified date even if revenue or income is insufficient.

7.2.3.3 Seller's Involvement in the Generation of the Cash Flows

If the entity has significant continuing involvement in the generation of the cash flows, it is presumed that the transaction represents debt. Such involvement might take the following forms:

- Manufacturing.
- Marketing.
- Distribution.
- Repairs and maintenance.
- Intellectual property protection.
- Customer service.
- Billing and handling of customer accounts.
- Decisions concerning delivery of service and operations.

The evaluation of whether the entity has significant involvement in the generation of the cash flows depends in part on whether the underlying cash flows originate from the entity's contractual arrangements or its operations. The September 14, 1988, EITF meeting materials state (in EITF Issue 88-18, Issue Summary 1, Supplement 1), in part:

In a licensing or other contractual arrangement, continuing involvement by the enterprise will vary based on the terms of the arrangement. For example, the licensing of a patent will usually require little ongoing activity by the enterprise except for protection from patent infringements whereas the enterprise's obligations under a franchise arrangement could be substantial, such as providing inventory, advertisement, and training. Timing and amount of cash flows generated from the operations of a subsidiary, business segment, or product line are normally under the control of the enterprise whose involvement is continuous.

At the 1997 AICPA Conference on Current SEC Developments, SEC Professional Accounting Fellow Armando Pimentel suggested that this criterion is often “very difficult to overcome . . . because the seller of the item generally continues to be involved in the marketing, promotion, or direct generation of the
asset’s cash flows. For example, if the seller continues to market and promote the asset, in order to preserve or improve the future cash flows to the investor, then the transfer would meet this rebuttable presumption.”

7.2.3.4 Cancellation Provisions
If either the seller or the investor has the right to cancel the transaction in exchange for a payment by the seller, the transaction is presumed to be debt. An agreement that is cancelable by the entity permits the entity to retain the benefits of revenue or income that exceeds expectations. An agreement that is cancelable by the investor limits the investor’s exposure to the risk that revenue or income will not meet expectations. Examples of cancellation provisions include call or prepayment features held by the seller and put features held by the buyer.

7.2.3.5 Limited Investor Rate of Return
If the investor’s rate of return is either explicitly or implicitly limited, the transaction is presumed to be debt. A cap on the rate of return limits the investor’s potential upside associated with changes in revenue or income. Examples of contractual limits include fixed repayment amounts or stated ceilings on total payments or rates of return.

7.2.3.6 Limited Investor Exposure to Variability
If the transaction terms are designed so that variations in the underlying revenue or income have, as described in ASC 470-10-25-2(e), “only a trifling impact on the investor’s rate of return,” the transaction is presumed to be debt. In such a case, the investor is not significantly exposed to the risks and rewards of changes in revenue or income in the transaction. For instance, if the entity is required to repay the proceeds received irrespective of the amounts of revenue generated, this criterion is met.

7.2.3.7 Investor Recourse Rights
If the investor has recourse to the seller (e.g., collateral), the transaction is presumed to be debt because recourse rights limit the investor’s exposure to reductions in the amount of revenue or income. Examples of recourse provisions include:

- Guaranteed minimum annual cash flows.
- Guaranteed minimum rates of return.
- Carryover provisions (if annual cash flows are insufficient, the buyer is entitled to recover any shortfall in the following year).
- Extensions of the term (the expected term of cash flows to generate the buyer’s return may be five years while the agreement is for eight years with a cap; the additional three years act as a guarantee).
- Acceleration provisions (if certain negative events occur, payments to the buyer are accelerated).

At the 1997 AICPA Conference on Current SEC Developments, Mr. Pimentel suggested that this criterion is often “very difficult to overcome, especially in cases where the transfer of the item is structured as an asset securitization. Typically, asset securitizations require the transferor to retain some type of recourse, either by transferring cash or other assets to the investor, or by subordinating future receipts from a retained interest.”
7.2.4 Debt Model

7.2.4.1 Initial Accounting

If the proceeds received in a sale of future revenue are accounted for as debt, the entity makes the following entry upon initial recognition:

\[
\begin{aligned}
\text{Cash (or other consideration received)} \\
\text{Debt}
\end{aligned}
\]

If the transaction includes the exchange of separate freestanding financial instruments or other rights or privileges (e.g., the buyer obtains a right to reduced pricing in future purchases of a product), the entity may need to allocate a portion of the proceeds received to such other units of account (see Section 3.4) before determining the initial carrying amount of the debt. Further, the entity should evaluate whether the amount recognized as debt contains any embedded feature (e.g., a contingent prepayment option) that must be bifurcated as a derivative instrument (see Chapter 8).

7.2.4.2 Subsequent Accounting

\[\text{ASC 470-10} \]

\[35-3 \text{ Amounts recorded as debt shall be amortized under the interest method (see Subtopic 835-30).} \ldots\]

After initial recognition, an entity uses the interest method (see Section 6.2) to account for the amount recorded as debt. Because sales of future revenues typically do not involve fixed contractual cash flows, the entity must make estimates of the timing and amount of the cash flows payable. While the effective interest rate is computed at inception by solving for the constant effective yield that equates the proceeds received to the future estimated payments (see Section 6.2.3.3), it would be inappropriate to apply a negative effective interest rate (see below).

In each period, the net carrying amount is the present value of the estimated future cash payments, discounted by using the effective interest rate (see Section 6.2.3.5). However, in the absence of a TDR, it would be inappropriate to reduce the debt's net carrying amount below the initial carrying amount (i.e., the proceeds), less payments previously made by the borrower to the investor, since ASC 450-30-25-1 precludes the recognition of contingent gains (see Section 6.2.5.5), and a debt obligation cannot be derecognized unless either of the extinguishment conditions in ASC 405-20-40-1 is met (see Section 9.2). Actual cash repayments are recorded as either interest expense or a reduction of the outstanding debt balance, including accrued interest, in accordance with the interest method.

Interest cost is accrued in each period by applying the effective interest rate against the debt's net carrying amount (see Section 6.2.3.4).

\[
\begin{aligned}
\text{Interest expense} \\
\text{Debt (or accrued interest)}
\end{aligned}
\]
**Example 7-5**

**Application of Interest Method to a Sale of Future Revenue**

Entity R enters into a sale-of-future-revenue arrangement within the scope of ASC 470-10 and determines that the arrangement must be accounted for as debt by applying the interest method in ASC 835-30. Entity R receives initial cash proceeds of $10 million. It prepares a preliminary amortization schedule on the basis of the initial proceeds and the estimated future cash payments shown in the second column of the table below. The final column shows the maximum remaining undiscounted cash flows that the entity could be required to be pay under the contractual terms (such payments are limited to a maximum amount of $5 million per year). (The effective interest rate of this series of cash flows is approximately 14.9 percent.)

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Preliminary Interest Expense</th>
<th>Preliminary Amortization</th>
<th>Preliminary Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X0</td>
<td>$(10,000,000)</td>
<td>—</td>
<td>—</td>
<td>$ 10,000,000</td>
</tr>
<tr>
<td>1/1/20X1</td>
<td>1,000,000</td>
<td>1,492,923</td>
<td>(492,923)</td>
<td>10,492,923</td>
</tr>
<tr>
<td>1/1/20X2</td>
<td>1,500,000</td>
<td>1,566,513</td>
<td>(66,513)</td>
<td>10,559,436</td>
</tr>
<tr>
<td>1/1/20X3</td>
<td>4,000,000</td>
<td>1,576,443</td>
<td>2,423,557</td>
<td>8,135,879</td>
</tr>
<tr>
<td>1/1/20X4</td>
<td>5,000,000</td>
<td>1,214,624</td>
<td>3,785,376</td>
<td>4,350,503</td>
</tr>
<tr>
<td>1/1/20X5</td>
<td>5,000,000</td>
<td>649,497</td>
<td>4,350,503</td>
<td>$ —</td>
</tr>
</tbody>
</table>

$ 6,500,000  $ 10,000,000

If the timing or amount of the actual or estimated cash flows changes, the effective interest rate or the net carrying amount (or both) may need to be updated (see Section 7.2.4.3 below).

### 7.2.4.3 Changes in Actual or Estimated Cash Flows

#### 7.2.4.3.1 Background

If the timing or amount of the actual or estimated cash flows changes, the original amortization schedule for the debt should be updated to reflect the revised cash flows, subject to the limitation on reducing the net carrying amount discussed in Section 7.2.4.2. An entity generally should apply one of the methods identified in the table below to account for changes in the amount or timing of cash flows.

<table>
<thead>
<tr>
<th>Updated Effective Interest Rate?</th>
<th>Updated Net Carrying Amount?</th>
<th>Immediate Earnings Effect?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prospective (see Section 7.2.4.3.2)</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Retrospective (see Section 7.2.4.3.3)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Cumulative catch-up (see Section 7.2.4.3.4)</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

The application of any of these methods is an entity-wide accounting policy election. Once an accounting policy has been adopted, ASC 250-10-45-11 requires the entity to use it consistently.
7.2.4.3.2 Prospective Interest Method

Under the prospective interest method, the entity recalculates the effective interest rate on the basis of the current carrying amount and the revised estimate of remaining future payments as of the date on which the estimate changes. This method of recognizing interest is similar to that in (1) ASC 470-50-40-14 related to debt modifications and exchanges that do not qualify for extinguishment accounting (see Section 10.4.3) and (2) ASC 470-60-35-5 related to TDRs in which the net carrying amount is less than the future cash flows (see Section 11.4.4.2).

Unlike the retrospective and catch-up methods, the prospective method does not require an entity to immediately adjust the current carrying amount of the debt or the recognition of a gain or loss in earnings as a result of the change in estimated cash flows. Instead, the change in the estimate of remaining future cash flows is recognized prospectively as a yield adjustment.

A benefit of the prospective interest method is that it is relatively simple to apply. As noted in paragraph 99 of FASB Concepts Statement 7, a drawback of this method is that it can “[obscure] the impact of changes in estimated cash flows.” Further, the “interest rate that is derived . . . is unrelated to the rate at initial recognition or to current market rates for similar assets and liabilities.”

Connecting the Dots

An entity may determine that because of a significant unexpected change in circumstances, the remaining undiscounted cash flows payable on a sale of future revenue that is accounted for as debt is less than the current net carrying amount of the debt. For example, assume that on January 1, 20X1, an entity receives cash proceeds of $25 million in return for repayment of a specified percentage of sales on a newly commercialized product. As of December 31, 20X2, the entity had adjusted the carrying amount of the debt obligation to $27 million, which included the recognition of interest expense of $5 million less cash payments made of $3 million. Further, assume that on March 31, 20X2, because of litigation related to the product that generates the repayments on the debt, the entity determines that it now expects the total future undiscounted cash flows payable to be only be $5 million.

On the basis of informal discussions with staff in the SEC's Office of the Chief Accountant (OCA), we understand that in such a situation, an entity that applies the prospective method could either (1) cease recognizing any interest on the debt (in which case it would apply the future cash payments to the net carrying amount of the debt until there is a change in future cash flow expectations or the debt is legally extinguished) or (2) amortize the net carrying amount (i.e., $27 million) to the initial carrying amount less the payments made (i.e., $22 million) on the basis of the interest method. Under the latter alternative, in the absence of a change in cash flow expectations, the entity would recognize interest income of $5 million over time (which reflects a reversal of the $5 million in interest expense previously recognized). The entity could not, however, reduce the net carrying amount below the initial amount borrowed less payments previously made since the conditions for liability extinguishment in ASC 405-20 would not be met on the basis of the revised expectations of future cash flows.

7.2.4.3.3 Retrospective Interest Method

Under the retrospective interest method, an entity periodically recalculates the effective interest rate on the basis of the rate that would have existed at the debt's inception and takes into account the original carrying amount, actual payments to date, and the revised estimate of remaining future payments. (However, the effective interest rate should not be reduced to the extent that the net carrying amount in any period would decline below the initial carrying amount less payments made to date; see Section 7.2.4.2.) Under this method, the debt's carrying amount is adjusted in each period to an
amount equal to the present value of the estimated remaining future payments, discounted by using the revised effective interest rate. The adjustment to the carrying amount is recognized in earnings as an adjustment to interest expense in the period in which it occurs.

This method is similar to the prepayment interest method discussed in ASC 310-20-35-26. Unlike the catch-up and prospective methods, the retrospective method requires an entity to adjust both the current carrying amount and the effective interest rate when the amount or timing of actual or estimated cash flows change. As noted in paragraph 100 of FASB Concepts Statement 7, a drawback of this method is that it “requires that entities retain a detailed record of all past cash flows.”

7.2.4.3.4 Cumulative Catch-Up Method

Under the cumulative catch-up method, the effective interest rate is not revised when actual or estimated cash flows change from those estimated as of the date on which the debt was issued. Instead, the debt's carrying amount is adjusted to an amount equal to the present value of the estimated remaining future payments, discounted by using the original effective interest rate as of the date on which the estimate changes. (However, the net carrying amount cannot be reduced to an amount less than the initial carrying amount less payments made to date; see Section 7.2.4.2.) The adjustment to the carrying amount is recognized in earnings as an adjustment to interest expense in the period in which the change in estimate occurred. Paragraph 98 of FASB Concepts Statement 7 suggests that this method is “consistent with the present value relationships portrayed by the interest method.”

7.2.5 Deferred Income Model

<table>
<thead>
<tr>
<th>ASC 470-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-3 Amounts . . . recorded as deferred income shall be amortized under the units-of-revenue method.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 470-10 Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Units-of-Revenue Method</strong></td>
</tr>
<tr>
<td>A method of amortizing deferred revenue that arises under certain sales of future revenues. Under this method, amortization for a period is calculated by computing a ratio of the proceeds received from the investor to the total payments expected to be made to the investor over the term of the agreement, and then applying that ratio to the period's cash payment.</td>
</tr>
</tbody>
</table>

If the proceeds received in a sale of future revenue are presented as deferred income, the entity makes the following entry on initial recognition:

Cash (or other consideration received)
Deferred income
Subsequently, the entity amortizes the amount of deferred income over time. At inception, the entity determines a unit-of-revenue method ratio equal to the fraction of the proceeds received to the total expected cash payments to be made over the term of the agreement. In each period, the amount of amortization is calculated by applying the unit-of-revenue method ratio to that period’s cash payment. Periodically, the ratio is updated to reflect changes in estimated cash flows. Under the deferred income method, no interest expense is accrued.

### 7.3 Participating Mortgages

#### 7.3.1 Background

ASC 470-30 addresses a debtor’s accounting for a participating mortgage, which is a mortgage loan that entitles the investor to share in either (or both) an increase in the market value of, or the income from, a mortgaged real estate project. Under ASC 470-30, the accounting depends on whether the participation involves market value appreciation (see Section 7.3.3) or the project’s results of operations (see Section 7.3.4).

#### 7.3.2 Scope

<table>
<thead>
<tr>
<th>ASC 470-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-1</strong> This Subtopic establishes the borrower’s accounting for a participating mortgage loan if the lender is entitled to participate in any of the following:</td>
</tr>
<tr>
<td>a. Appreciation in the fair value of the mortgaged real estate project</td>
</tr>
<tr>
<td>b. The results of operations of the mortgaged real estate project.</td>
</tr>
<tr>
<td><strong>05-2</strong> The desire for instruments in which the return to the lenders was tied more closely to the performance of the property led to the introduction of participating mortgage loans.</td>
</tr>
<tr>
<td><strong>05-3</strong> Participating mortgage loans and nonparticipating mortgage loans share all of the following characteristics:</td>
</tr>
<tr>
<td>a. Debtor-creditor relationships between those who provide initial cash outlays and hold the mortgages, and those who are obligated to make subsequent payments to the mortgage holders</td>
</tr>
<tr>
<td>b. Real estate collateral</td>
</tr>
<tr>
<td>c. Periodic fixed-rate or floating-rate interest payments</td>
</tr>
<tr>
<td>d. Fixed maturity dates for stated principal amounts.</td>
</tr>
<tr>
<td><strong>05-4</strong> However, unlike a nonparticipating mortgage loan arrangement, in a participating mortgage loan, the lender participates in appreciation in the fair value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or in both.</td>
</tr>
<tr>
<td><strong>05-5</strong> The terms and economics of participating mortgage loan agreements vary by agreement. The terms and economics of one agreement may create a circumstance in which any participation payment is remote. In another agreement, the terms and economics may transfer many of the risks and rewards of property ownership.</td>
</tr>
<tr>
<td><strong>05-8</strong> The participation terms of a participating mortgage loan agreement usually are negotiated concurrently with the other terms of the underlying mortgage loan. A borrower agrees to participation rights generally because of market conditions, or in exchange for concessions granted by the lender on some other term(s) of the loan, such as a lower interest rate or a higher loan-to-value ratio.</td>
</tr>
</tbody>
</table>
The lender's participation reduces the borrower's potential realization of operating results or gain on the sale of the real estate. However, the participation also may reduce any of the following:

a. The contract interest the borrower is required to pay
b. The risk that the borrower will be unable to pay interest at the stated or floating rate in the loan agreement and, consequently, the risk that the borrower will default on the loan and need to sell the property
c. The amount of capital the borrower has at risk, because the loan-to-value ratio normally is higher.

Further, the obligation to pay the lender a share of the property appreciation does not increase the current exposure of the borrower to loss in its investment, because the participation payments are made only if the fair value of the property appreciates.

The guidance in this Subtopic applies to the following entities:

a. All borrowers in participating mortgage loan arrangements.

The guidance in this Subtopic does not apply to the following entities:

a. Creditors in participating mortgage loan arrangements.

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

a. Participating leases
b. Debt convertible at the option of the lender into equity ownership of the property
c. Participating loans resulting from troubled debt restructurings.

In exchange for allowing the creditor to participate in the real estate project that is financed by a loan, the debtor might receive a reduced interest rate, more favorable debt covenants, or other benefits. Paragraph 21 of the Basis for Conclusions of SOP 97-1 states:

In a participating mortgage loan arrangement, the lender generally grants certain concessions to the borrower in return for the right to participate in either the appreciation in the market value of the mortgaged real estate project or the operations of the mortgaged real estate project, or in both. A common concession is granting an interest rate lower than that which would have been included in a comparable nonparticipating mortgage loan. Another common concession is a higher loan-to-value ratio than would be allowed at the same interest rate in a loan that does not include the participation in appreciation. AcSEC believes that in participating loan arrangements, the borrower has received something of value (the lower interest rate) in exchange for something of value (the participation feature) and that such exchanges should be given accounting recognition.

The guidance in ASC 470-30 does not apply to (1) participating mortgages for which the borrower has elected the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4), (2) participating leases, (3) debt that is convertible into an ownership interest in the mortgaged property, or (4) participating loans resulting from TDRs under ASC 470-60 (see Chapter 11). If a participation feature in a debt obligation is contingent on the sale of the property (e.g., a requirement to pay 20 percent of any sales proceeds) and the borrower has no obligation to sell the property, ASC 470-30 does not apply because the lender is not entitled to participate unless the borrower elects to sell the property. Further, the guidance in ASC 470-30 applies only to debt with a participation feature that does not represent a separate unit of account (see Section 3.3). If the participation feature is a separate unit of account that is not subject to other applicable GAAP (e.g., derivative accounting), the issuer should consider the indexed-debt guidance that applies to separable contingent payments (see Section 7.4).
Typically, participation features in participating mortgage loans are not bifurcated as derivative instruments under ASC 815-15. There are scope exceptions in ASC 815-10-15-59 to the derivative accounting requirements for non-exchange-traded contracts whose underlying on which the settlement is based is either (1) the price or value of a nonfinancial asset of one of the parties of the contract provided that the asset is not readily convertible to cash (if the nonfinancial asset is unique and the nonfinancial asset is owned by the party that would not benefit from an increase in the fair value of the nonfinancial asset; see Section 8.4.9.5) or (2) specified volumes of sales or service revenues of one of the parties to the contract (see Section 8.4.10.5). ASC 815-15-55-8 and 55-9 contain the following illustration of a participation feature that is exempt from the scope of ASC 815:

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-8</strong> Under an example participating mortgage, the investor receives a below-market interest rate and is entitled to participate in the appreciation in the fair value of the project that is financed by the mortgage upon sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. The mortgagor must continue to own the project over the term of the mortgage.</td>
</tr>
<tr>
<td><strong>55-9</strong> This instrument has a provision that entitles the investor to participate in the appreciation of the referenced real estate (the project). However, a separate contract with the same terms would be excluded by the exception in paragraph 815-10-15-59(b) because settlement is based on the value of a nonfinancial asset of one of the parties that is not readily convertible to cash. (This Subtopic does not modify the guidance in Subtopic 470-30.)</td>
</tr>
</tbody>
</table>

It may be appropriate for an entity to apply the participating mortgage guidance by analogy to other financial instruments that pay amounts on the basis of the issuer's own operations unless the feature must be bifurcated as a derivative instrument under ASC 815-15 or other accounting requirements apply.

### 7.3.3 Participation in Market Value Appreciation

#### 7.3.3.1 Background

<table>
<thead>
<tr>
<th>ASC 470-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-6</strong> A lender may be entitled to participate in appreciation in the fair value of a project at any one of the following times:</td>
</tr>
<tr>
<td>a. Upon the sale of the project</td>
</tr>
<tr>
<td>b. At a deemed sale date</td>
</tr>
<tr>
<td>c. At the maturity or refinancing of the loan.</td>
</tr>
</tbody>
</table>

In exchange for more favorable debt terms, a debtor might permit the creditor to participate in the appreciation in the value of the mortgaged property (e.g., 25 percent of any increase in the value of the property in excess of the initially appraised value). That participation feature might be payable on earliest of the loan's maturity date, the sale of the property, or the refinancing of the loan.
7.3.3.2 Initial Accounting

ASC 470-30

25-1 If a lender is entitled to participate in the appreciation of the market value of a mortgaged real estate project, the borrower shall recognize a participation liability with a corresponding debit to a debt discount account.

30-1 If the lender is entitled to participate in appreciation in the fair value of the mortgaged real estate project, the borrower shall determine the fair value (see Subtopic 820-10) of the participation feature at the inception of the loan (see paragraph 470-30-25-1 for guidance on how to recognize the participation feature).

ASC 470-30 requires that when the lender participates in the appreciation of the mortgaged real estate project's market value, the debtor must recognize a participation liability equal to the fair value of the participation feature at the inception of the loan. The offsetting entry is recognized as a discount on the debt, which is amortized as an adjustment to interest cost over the life of the loan.

For example, the debtor might make the following entry on initial recognition:

Cash (or other consideration received)
Mortgage loan discount
  Mortgage loan
  Participation feature (at fair value)

7.3.3.3 Subsequent Accounting

ASC 470-30

35-1 The debt discount shall be amortized by the interest method, using the effective interest rate.

35-2 Interest expense on participating mortgage loans consists of the following three components:
   a. Amounts designated in the mortgage agreement as interest
   b. Amounts related to the lender's participation in results of operations
   c. Amortization of debt discount related to the lender's participation in the fair value appreciation of the mortgaged real estate project.

35-4A If a lender is entitled to participate in the appreciation of the market value of a mortgaged real estate project, both of the following are required at the end of each reporting period:
   a. The balance of the participation liability shall be adjusted to equal the current fair value of the participation feature.
   b. The corresponding debit or credit shall be recorded in the related debt-discount account.

35-5 The revised debt discount shall be amortized prospectively, using the effective interest rate.

45-1 The amortization of the debt discount relating to the participation liability shall be included in interest expense.
After the inception of the loan, the participation liability is adjusted for any changes in the fair value of the participation feature so that its measurement equals its current fair value as of the reporting date, with a corresponding offset to the debt discount. For example, if the fair value of the participation feature increases, the debtor would make the following entry:

\[
\text{Mortgage loan discount} \\
\text{Participation feature (increase in fair value)}
\]

If the fair value of the participation feature decreases, the debtor would make the following entry:

\[
\text{Participation feature (decrease in fair value)} \\
\text{Mortgage loan discount}
\]

The adjusted debt discount is amortized prospectively to interest expense by adjusting the debt's effective interest rate over its remaining life (see Section 6.2.3.3). This means that although changes in the fair value of a market value participation feature in a participating mortgage are reflected immediately on the debtor's balance sheet, they are not recognized immediately in net income. Instead, they are recognized over time through a prospective yield adjustment that affects the recognition of interest expense over the debt's remaining life.

Generally, both increases and decreases in the fair value of the participation feature are recognized. However, ASC 470-30-35-3 precludes subsequent reversals of appreciation once interest amounts have been capitalized under ASC 835-20.

Periodic interest expense for mortgage loans that entitle the lender to participate in the market value appreciation of the mortgaged real estate project include amounts designated in the mortgage agreement as interest and the periodic amortization of the debt discount created by the participation liability. These amounts should be recognized by using the interest method (see Section 6.2). If the investor also participates in the results of the mortgaged real estate project's operations, such amounts are recognized as interest expense as they become due (see Section 7.3.4.3).

### 7.3.3.4 Example

<table>
<thead>
<tr>
<th>ASC 470-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 1: Accounting by Participating Mortgage Loan Borrower</strong></td>
</tr>
<tr>
<td><strong>55-1</strong> This Example illustrates the guidance in this Subtopic.</td>
</tr>
<tr>
<td><strong>55-2</strong> Assume that on January 1, 19X1, Borrower Co. purchased a property for $10 million. On that date, Borrower paid $1 million cash and entered into a participating mortgage loan agreement with Lender Co. in the amount of $9 million.</td>
</tr>
<tr>
<td><strong>55-3</strong> The loan agreement has the following terms:</td>
</tr>
<tr>
<td>a. 15 year term</td>
</tr>
<tr>
<td>b. Interest-only periodic payments, principal to be repaid at end of term</td>
</tr>
<tr>
<td>c. 5% stated interest rate</td>
</tr>
<tr>
<td>d. 20% participation in appreciation in the value of the property above $10 million, payable at maturity (or earlier if the asset is sold or the loan is refinanced).</td>
</tr>
</tbody>
</table>
Assumptions related to the fair value of the participation feature are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Value</th>
<th>Estimated Payment</th>
<th>Years in Future</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>$25,055</td>
<td>$300,000</td>
<td>15</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>40,063</td>
<td>320,000</td>
<td>14</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>54,122</td>
<td>333,000</td>
<td>13</td>
</tr>
</tbody>
</table>

Based on the preceding assumptions, Borrower Co. should make the following journal entries for this participating mortgage loan.

a. On January 1, 19X1, the following journal entries should be recorded:

\[
\begin{align*}
\text{Cash} & \quad \$9,000,000 \\
\text{Loan discount} & \quad 25,055 \\
\end{align*}
\]

To record participating debt and estimate of participation liability (based on fair value of participation feature).

\[
\begin{align*}
\text{Property} & \quad \$10,000,000 \\
\text{Cash} & \quad 10,000,000 \\
\end{align*}
\]

To record purchase of property.

b. By the end of 19X1, entries to record interest expense and amortization of discount throughout the year would have taken the following form:

\[
\begin{align*}
\text{Interest expense} & \quad \$451,159 \\
\text{Interest payable} & \quad 450,000 \\
\text{Loan discount} & \quad 1,159 \\
\end{align*}
\]

To record interest expense and amortization of debt discount using the interest method and an effective rate of 5.03 percent (rounded).

\[
\begin{align*}
\text{Loan discount} & \quad \$15,008 \\
\text{Participation liability} & \quad 15,008 \\
\end{align*}
\]

To adjust balance of participation liability to fair value at end of period. The adjustment is calculated as follows:

\[
\begin{align*}
\text{Fair value at 12/31/X1} & \quad \$40,063 \\
\text{Fair value at 1/1/X1} & \quad 25,055 \\
\text{Adjustment} & \quad 15,008 \\
\end{align*}
\]

Note: For purposes of this illustration, the fair value of the participation feature at 12/31/X1 is based on a revised estimate of the equity participation that would be payable in fourteen years of $320,000.
At the end of 19X2, entries to record interest expense and amortization of discount throughout the year would have taken the following form:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>$451,979</td>
</tr>
<tr>
<td>Interest payable</td>
<td>450,000</td>
</tr>
<tr>
<td>Loan discount</td>
<td>1,979</td>
</tr>
</tbody>
</table>

To record interest expense and amortization of debt discount, using the interest method and an effective rate of 5.04 percent (rounded).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan discount</td>
<td>$14,059</td>
</tr>
<tr>
<td>Participation liability</td>
<td>14,059</td>
</tr>
</tbody>
</table>

To adjust recorded participation liability of $40,063 to fair value at 12/31/X2 of $54,122.

### 7.3.4 Participation in Results of Operations

#### 7.3.4.1 Background

In agreements in which lenders participate in results of operations, the definition of the results of operations may vary among agreements. Examples of these definitions include, but are not limited to, the following:

a. Revenue
b. Income
c. Cash flows before or after debt service.

In exchange for more favorable debt terms, a debtor might allow a creditor to participate in the results of operations of a real estate project. For example, the debtor and creditor might agree to share in the revenue, net income, or net cash flows of a mortgaged office or apartment building.

#### 7.3.4.2 Initial Accounting

ASC 470-30 prescribes an accounting model for mortgage loans for which the lender participates in the results of operations of the mortgaged real estate project that is different from the accounting model for market value participation features. Under ASC 470-30, the borrower recognizes no liability for the fair value of the participation feature at inception. Instead, a participation liability is recognized as amounts become contractually due.

Therefore, the debtor might make the following entry on initial recognition:

Cash (or other consideration received)

Mortgage loan
### 7.3.4.3 Subsequent Accounting

<table>
<thead>
<tr>
<th>ASC 470-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-2</strong> Interest expense on participating mortgage loans consists of the following three components:</td>
</tr>
<tr>
<td>a. Amounts designated in the mortgage agreement as interest</td>
</tr>
<tr>
<td>b. Amounts related to the lender’s participation in results of operations</td>
</tr>
<tr>
<td>c. Amortization of debt discount related to the lender’s participation in the fair value appreciation of the mortgaged real estate project.</td>
</tr>
</tbody>
</table>

| **35-4** | Amounts due to a lender pursuant to the lender’s participation in the real estate project’s results of operations (as defined in the participating mortgage loan agreement) shall be charged to interest expense in the borrower’s corresponding financial reporting period, with a corresponding credit to the participation liability. |

Interest expense on mortgage loans that participate in the results of operations consist of the amounts designated in the loan agreement as interest as well as amounts that become due to the creditor related to the participation feature in the results of operations. The participation feature in the results of operations is not separately recognized by the borrower before amounts become due. When amounts become due, the debtor recognizes a corresponding charge to the income statement (interest expense). For example, the debtor might make the following entry when it becomes legally obligated to pay such amounts:

```
Interest expense
  Mortgage loan (or accrued mortgage participation liability)
```

A creditor that participates in both market value appreciation and results of operations of the mortgaged real estate project applies the guidance on such participation features when accounting for the participation in market value appreciation (see Section 7.3.3).

### 7.3.5 Other Considerations

#### 7.3.5.1 Variable-Rate Participating Mortgages

<table>
<thead>
<tr>
<th>ASC 470-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-3</strong> Amounts designated in the mortgage agreement as interest shall be charged to income in the period in which the interest is incurred. If the loan’s stated interest rate varies based on changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate [LIBOR], or the U.S. Treasury bill weekly average rate), the calculation of the interest shall be based on the factor (the index or the rate) as it changes over the life of the loan. Interest recognized pursuant to this guidance is subject to the requirements of Subtopic 835-20. Once capitalized, amounts shall not be adjusted for the effects of reversals of appreciation.</td>
</tr>
</tbody>
</table>

The amount that is reported as interest expense for a participating mortgage loan includes the stated interest rate, amounts due to the lender for its participation in the real estate project’s results of operations (see Section 7.3.4.3 above), and the amortization of any debt discount associated with a participation liability in the real estate project’s fair value appreciation (see Section 7.3.3). For stated interest rates that vary on the basis of changes in a reference interest rate index (such as a prime rate or benchmark interest rate), ASC 470-30 requires the debtor to accrue the amounts designated as interest in accordance with the interest rate in effect in each period as such rate changes over the debt’s life (see also Section 6.2.5.2).
7.3.5.2 Extinguishments

<table>
<thead>
<tr>
<th>ASC 470-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>40-1 If the participating mortgage loan is extinguished before its due date, the difference between the recorded amount of the debt (including the unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt is a debt extinguishment gain or loss.</td>
</tr>
<tr>
<td>45-2 If the participating mortgage loan is extinguished before its due date, the debt extinguishment gain or loss shall be reported as required by paragraph 470-50-40-2.</td>
</tr>
</tbody>
</table>

The borrower should apply the general derecognition guidance for liabilities in ASC 405-20 (see Chapter 9) and ASC 470-50 (see Chapter 10). The computation of the debt extinguishment gain or loss is based on a comparison of the reacquisition price with the net carrying amount of the debt. The net carrying amount includes any related participation liability and any unamortized debt discount. Because ASC 470-30 requires entities to measure participation liabilities related to the market value appreciation of the mortgaged real estate project at their fair value on a recurring basis, the debtor should update its estimate of the fair value of a participation liability as of the extinguishment date.

7.3.5.3 Disclosure

<table>
<thead>
<tr>
<th>ASC 470-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-1 The borrower’s financial statements shall disclose both of the following:</td>
</tr>
<tr>
<td>a. The aggregate amount of participating mortgage obligations at the balance sheet date, with separate disclosure of the aggregate participation liabilities and related debt discounts</td>
</tr>
<tr>
<td>b. Terms of the participations by the lender in either the appreciation in the fair value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or both.</td>
</tr>
</tbody>
</table>

ASC 470-30 requires entities to provide additional disclosures beyond those that otherwise apply to debt instruments.

7.4 Indexed Debt

7.4.1 Background

ASC 470-10 includes guidance on the issuer’s accounting for certain debt instruments that require the issuer to make both guaranteed and contingent payments that are linked to a specific price or index. That guidance is based on EITF Issue 86-28, which was published before the FASB’s issuance of the guidance on embedded derivatives that is codified in ASC 815-15. Since the indexation feature in most of the debt instruments originally addressed in Issue 86-28 requires bifurcation under ASC 815-15 as an embedded derivative, the indexed-debt guidance in ASC 470-10 applies to a limited population of those instruments. That is, such guidance applies only to certain contingent payment obligations that do not need to be separated as embedded derivatives under ASC 815-15 (see Chapter 8) and are not subject to other GAAP.
7.4.2 Scope

ASC 470-10

Debt instruments may be issued with both guaranteed and contingent payments. The contingent payments may be linked to the price of a specific commodity (for example, oil) or a specific index (for example, the S&P 500). In some instances, the investor’s right to receive the contingent payment (an indexing feature) is separable from the debt instrument. If the indexing feature does not warrant separate accounting under ASC 815 or the instrument does not meet the definition of a derivative under Topic 815, the entire instrument shall be accounted for in accordance with paragraphs 470-10-25-4 and 470-10-35-4.

The guidance on indexed debt instruments in ASC 470-10 applies to debt instruments that are issued with both guaranteed (fixed) and contingent (indexed) payments. The contingent payment obligation might be embedded in the debt (see Section 7.4.3 below) or legally separable from it (see Section 7.4.4). However, the indexed-debt guidance does not apply if (1) the contingent payment obligation is subject to derivative accounting under ASC 815 (see Chapter 8), (2) the issuer has elected the fair value option under ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4), or (3) the indexed debt is within the scope of guidance on sales of future revenue in ASC 470-10 (see Section 7.2) or participating mortgages in ASC 470-30 (see Section 7.3).

In many cases, indexation features must be accounted for as derivatives under ASC 815-15 because (1) changes in a commodity price or index (e.g., the price of gold) or in an equity price or index (e.g., S&P 500) are not considered clearly and closely related to a debt host contract (see Sections 8.4.9.3 and 8.4.7.3.2) and (2) contingent features that are explicitly cash settled meet the net settlement characteristic in the definition of a derivative (see Section 8.3.4.4). If the indexation feature is accounted for as a derivative, the indexed-debt guidance in ASC 470-10 does not apply; if the feature is not subject to derivative accounting, the issuer should evaluate whether to apply the indexed-debt guidance.

Examples of debt instruments that could be within the scope of the indexed-debt guidance include debt securities whose principal or interest payments vary on the basis of:

- An inflation index, such as CPI, that is considered clearly and closely related to the debt host (see Section 8.4.3.3).
- A nonfinancial asset if the indexation feature does not have to be separated as a derivative under ASC 815-15 (e.g., the nonfinancial asset is unique, not readily convertible to cash, and owned by a party to the contract; see Section 8.4.9.5).

7.4.3 Embedded Indexation Feature

Upon initial recognition of a debt instrument within the scope of the indexed-debt guidance in ASC 470-10, no proceeds are allocated to an indexation feature that is embedded in the debt. However, subsequent changes in the intrinsic value of the feature must be recognized (see Section 7.4.5).

7.4.4 Separate Indexation Features

ASC 470-10

If the investor’s right to receive the contingent payment is separable, the proceeds shall be allocated between the debt instrument and the investor’s stated right to receive the contingent payment. The premium or discount on the debt resulting from the allocation shall be accounted for in accordance with Subtopic 835-30.
If a contingent payment obligation within the scope of the indexed-debt guidance in ASC 470-10 is legally separable from the related debt instrument (i.e., it is a freestanding financial instrument; see Section 3.3), the proceeds received for the debt should be allocated between the debt and the investor's right to receive contingent payments upon initial recognition. The discount (or reduced premium) on the debt instrument from such allocation should be accounted for in accordance with the interest method (see Section 6.2).

ASC 470-10 does not specify the method for allocating the proceeds between the debt liability and the separable contingent payment obligation. As a result, various allocation approaches for separating the contingent payment feature may be acceptable, including the following:

- **Relative fair value** — The proceeds are allocated between the debt and the contingent payment obligation on the basis of the relative fair values of each component. This approach is consistent with the allocation method discussed in ASC 470-20-25-2 (see Section 3.4.2.3).

- **Fair value of debt component** — The proceeds are allocated between the debt and the contingent payment obligation by first recognizing the carrying amount of the debt on the basis of the fair value of a similar debt instrument without the contingent payment obligation. The contingent payment obligation is then recognized as the difference between the proceeds received upon issuance and the carrying amount of the debt (i.e., a residual amount). This approach is consistent with the separation method for convertible debt with CCFs under ASC 470-20 (see Section 7.6.4).

- **Fair value of contingent payment obligation** — The proceeds are allocated between the debt and the contingent payment obligation by first recognizing the carrying amount of the contingent payment obligation on the basis of the fair value of such component. The debt is then recognized as the difference between the proceeds received upon issuance and the carrying amount of the contingent payment obligation (i.e., a residual amount). This approach is consistent with how proceeds are allocated when a freestanding financial instrument is subsequently measured at fair value, with changes in fair value recognized in earnings (see Section 3.4.2.2).

Even though the separable contingent payment obligation is subsequently remeasured on the basis of its intrinsic value (see Section 7.4.5 below), entities would generally not allocate the proceeds on the basis of the intrinsic value of the contingent payment obligation as of the issuance date of the debt because to do so would generally result in the allocation of no amount to the contingent payment obligation (i.e., the obligation has no intrinsic value at inception).

### 7.4.5 Intrinsic Value Method

<table>
<thead>
<tr>
<th><strong>ASC 470-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-4</strong> As the applicable index value increases such that an issuer would be required to pay an investor a contingent payment at maturity, the issuer shall recognize a liability for the amount that the contingent payment exceeds the amount, if any, originally attributed to the contingent payment feature. The liability for the contingent payment feature shall be based on the applicable index value at the balance sheet date and shall not anticipate any future changes in the index value. When no proceeds are allocated originally to the contingent payment, the additional liability resulting from the fluctuating index value shall be accounted for as an adjustment of the carrying amount of the debt obligation.</td>
</tr>
</tbody>
</table>
ASC 470-10 requires the issuer to apply an intrinsic value approach to the measurement of contingent payment obligations in indexed debt instruments. The intrinsic value is determined on the basis of the applicable index value as of the balance sheet date and does not take into account future changes in the index value (e.g., on the basis of projections or forward market prices). In other words, the liability measurement is based on the settlement amount that would be payable on the basis of the conditions as of the reporting date.

Changes in the index value of an indexed debt instrument are accounted for as adjustments to the carrying amount of the (1) debt obligation (if embedded) or (2) contingent payment liability (if separable). Such changes should be recognized in the income statement as they occur (e.g., as interest expense).

At the 1997 AICPA Conference on Current SEC Developments, SEC Professional Accounting Fellow Russell Mallett stated, in part:

> While accounting practice typically recognizes changes in a debt obligation in the income statement, the [EITF] . . . did not reach a consensus on this point, although a majority of the Task Force believed expense treatment was appropriate.

Further, Mr. Mallett provided an example of an indexed debt instrument with a floor on the settlement amount equal to the original principal amount and suggested that such an index feature essentially is an embedded written option. He further noted that “generally, the staff believes that the obligations resulting from written options should be recognized in the balance sheet and changes in those obligations should be recognized immediately in the income statement. Therefore, consistent with the [indexed-debt] guidance in [ASC 470-10], the staff concluded that the indexed debt obligation should be adjusted based on the changes in the [index value] at each balance sheet date and that any changes in the obligation should be recognized in the income statement.”

The cumulative amount of additional expense recognized for the contingent payment obligation should not be less than zero. That is, while previously recognized additional expense may potentially be reversed in a subsequent financial reporting period if the index value declines, the cumulative total expense recognized should not be less than zero. An expectation that the issuer will not be required to repay the initial amount of the obligation is akin to a contingent gain that should be recognized only if or when the payment obligation is legally extinguished under ASC 405-20 (see Section 9.2).

### 7.5 Joint-and-Several Liability Arrangements

#### 7.5.1 Background

In a joint-and-several liability arrangement, two or more entities are co-obligors with respect to the same obligation. Because each co-obligor is a primary obligor, the creditor can demand repayment of the full amount of the obligation from any of the co-obligors. A co-obligor cannot refuse to pay the full amount even if it did not borrow that amount. Depending on what the co-obligors have agreed to among themselves and under any applicable laws, however, a co-obligor that has paid amounts to the creditor on behalf of other co-obligors might be able to seek repayment of such amounts from its co-obligors.

<table>
<thead>
<tr>
<th>ASC 405-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-1</strong> This Subtopic addresses the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements.</td>
</tr>
</tbody>
</table>
Example 7-6

Joint-and-Several Debt Instrument
Two entities each borrow $200 under a joint-and-several liability debt arrangement. The creditor can demand repayment of up to $400 from either of the two co-obligors when the debt becomes due even though each of them only received $200 of debt proceeds.

7.5.2 Scope

ASC 405-40

15-1 The guidance in this Subtopic applies to obligations resulting from joint and several liability arrangements for which the total amount under the arrangement is fixed at the reporting date, except for obligations otherwise accounted for under the following Topics:

a. Asset Retirement and Environmental Obligations, see Topic 410
b. Contingencies, see Topic 450
c. Guarantees, see Topic 460
d. Compensation — Retirement Benefits, see Topic 715
e. Income Taxes, see Topic 740.

For the total amount of an obligation under an arrangement to be considered fixed at the reporting date there can be no measurement uncertainty at the reporting date relating to the total amount of the obligation within the scope of this Subtopic. However, the total amount of the obligation may change subsequently because of factors that are unrelated to measurement uncertainty. For example, the amount may be fixed at the reporting date but change in future periods because an additional amount was borrowed under a line of credit for which an entity is jointly and severally liable or because the interest rate on a joint and several liability arrangement changed.

15-2 Although the total amount of the obligation of the entity and its co-obligors must be fixed at the reporting date to be within the scope of this Subtopic, the amount that the entity expects to pay on behalf of its co-obligors may be uncertain at the reporting date.

25-1 An entity shall recognize obligations resulting from joint and several liability arrangements when the arrangement is included in the scope of this Subtopic. In some circumstances, the arrangement is included in the scope of this Subtopic at the inception of the arrangement (for example, a debt arrangement); in other circumstances, the arrangement is included in the scope of this Subtopic after the inception of the arrangement (for example, when the total amount of the obligation becomes fixed, consistent with paragraph 405-40-15-1).

ASC 405-40 applies to all entities that have obligations resulting from joint-and-several liability arrangements regardless of the relationship among the parties involved in the agreement. Examples of obligations that may be subject to joint-and-several liability include debt obligations, line-of-credit arrangements, settled litigation, and judicial rulings. However, ASC 405-40 does not apply to obligations within the scope of other Codification topics (including ASC 410, ASC 450, ASC 460, ASC 715, and ASC 740). For example, if an entity is a guarantor or co-guarantor of a debt arrangement and the creditor can seek repayment from the entity only if the creditor has been unable to collect amounts due from the debtor, the entity would apply the guidance on guarantees in ASC 460, not ASC 405-40. Paragraph BC8 of ASU 2013-04 states, in part:

One of the significant differences between a joint and several liability arrangement and a guarantee arrangement is that an entity is a primary obligor under a joint and several liability arrangement and is a secondary obligor under a guarantee arrangement.
The scope of ASC 405-40 is limited to arrangements for which the total amount is fixed as of the reporting date. For the total amount to be considered fixed, it cannot be subject to measurement uncertainty (such as uncertainty associated with ongoing litigation). As noted in paragraph BC6 of ASU 2013-04, liabilities that are subject to measurement uncertainty are accounted for under ASC 450 or other GAAP. If the measurement uncertainty is resolved after the inception of the arrangement (e.g., settled litigation), ASC 405-40 applies when the total amount becomes fixed. The total amount would be considered fixed as of the reporting date even if (1) the portion the entity expects to pay among its co-obligors is subject to measurement uncertainty or (2) the total amount varies over time because of factors unrelated to measurement uncertainty (e.g., an additional amount was borrowed or the interest rate changed).

### 7.5.3 Measurement

<table>
<thead>
<tr>
<th>ASC 405-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-1</strong> Obligations resulting from joint and several liability arrangements included in the scope of this Subtopic initially shall be measured as the sum of the following:</td>
</tr>
<tr>
<td>a. The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors.</td>
</tr>
<tr>
<td>b. Any additional amount the reporting entity expects to pay on behalf of its co-obligors. If some amount within a range of the additional amount the reporting entity expects to pay is a better estimate than any other amount within the range, that amount shall be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range shall be the additional amount included in the measurement of the obligation.</td>
</tr>
<tr>
<td><strong>35-1</strong> Obligations resulting from joint and several liability arrangements included in the scope of this Subtopic subsequently shall be measured using the guidance in Section 405-40-30.</td>
</tr>
</tbody>
</table>

Upon initial recognition and on each subsequent measurement date, obligations within the scope of ASC 405-40 are measured as the sum of (1) the amount the entity has agreed to pay under the arrangement among the co-obligors (i.e., the amount the entity has agreed to be ultimately liable for; not the full amount) and (2) any additional amount the entity expects to pay on behalf of its co-obligors (e.g., because a co-obligor is expected to be unable to pay some or all of the amount it has agreed to be liable for among its co-obligors).

In determining how much it has agreed to pay under the arrangement among the co-obligors, the entity should consider any written agreements among the co-obligors as well as other facts and circumstances. In the absence of a written agreement between the parties, factors that could result in a conclusion that there is an implicit agreement include information about how the parties have acted in the past, which party received the proceeds, and which party has made principal repayments or interest settlements.

In determining any additional amount it expects to pay on behalf of its co-obligors, the entity applies a measurement approach similar to that for loss contingencies in ASC 450-20 (see Deloitte's *A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees*). That is, if a best estimate of the additional amount is available, the entity should record that amount. If there is a range of potential estimates and some amount within the range is a better estimate than any other amount within the range, the best estimate should be recorded. If no amount within the range is a better estimate than any other amount, the minimum amount within the range should be recorded.
Example 7-7

Initial Recognition of Joint-and-Severall Debt Instrument

Company A and Company B co-issue and are jointly and severally liable for $400 of debt. The total amount of the obligation for the debt is fixed as of the reporting date. The joint-and-severall obligation is within the scope of ASC 405-40. The arrangement between A and B states that A agrees to pay the full $400 obligation, and B does not expect to pay additional amounts on behalf of A.

Accordingly, A would record a liability of $400, and B would not record any liability because it has not agreed to pay any amount and does not expect to pay additional amounts on behalf of A.

Example 7-8

Initial Recognition of Joint-and-Severall Debt Instrument — Allocation Among Obligors

Assume the same facts as in Example 7-7, except that the arrangement between A and B states that each party will pay $200. In this scenario, A and B would record a liability of $200 because each has agreed to pay that amount and neither expects to pay additional amounts on behalf of the other party.

Example 7-9

Initial Recognition of Joint-and-Severall Debt Instrument — Total Amount Recognized by Parties Exceeds Total Amount of Obligation

Assume the same facts as in Example 7-8, except that A expects to pay between $100 and $200 on behalf of B. In this scenario, A would record $300 and B would record $200 of liabilities for the debt. Each would record the amount it agreed to pay on the basis of the arrangement with its co-obligor (i.e., $200). In addition, A would record $100 of liabilities, which represents the minimum amount in the range of $100 to $200 that A expects to pay on behalf of B (its co-obligor) because no other amount in the range is a better estimate of what A expects it would pay (see ASC 405-40-30-1(b)).

7.5.4 Offsetting Entry

ASC 405-40

25-2 The corresponding entry or entries shall depend on facts and circumstances of the obligation. Examples of corresponding entries include the following:

a. Cash for proceeds from a debt arrangement
b. An expense for a legal settlement
c. A receivable (that is assessed for impairment) for a contractual right
d. An equity transaction with an entity under common control.

30-2 The corresponding entry or entries shall depend on the facts and circumstances of the obligation.

ASC 405-40 does not prescribe the specific offsetting entry or entries an entity should make when recognizing or remeasuring the liability in a joint-and-several liability arrangement. Accordingly, an entity must use judgment and consider the facts and circumstances.

To the extent that an entity has received cash for amounts it has borrowed under a joint-and-several liability arrangement, the appropriate offsetting entry would be to cash. If the entity expects to pay amounts on behalf of co-obligors, the offsetting entry for such amounts depends on whether the entity has a contractual right to recover those amounts from its co-obligors (e.g., under a side agreement). If it
has such a right, it should record a receivable and evaluate it for impairment under ASC 310 or ASC 326 (see Deloitte’s *A Roadmap to Accounting for Current Expected Credit Losses*), as applicable. If the entity has no such right, the appropriate offsetting entry might be an expense. Any expected recoveries (e.g., if the entity sues its co-obligors) would be evaluated as a contingency under ASC 450-20 and ASC 450-30 (see Deloitte’s *A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees*). Paragraph BC12 of ASU 2013-04 states, in part:

In instances in which a legal or contractual arrangement exists to recover amounts funded under a joint and several obligation from the co-obligors, the Task Force noted that a receivable could be recognized at the time the corresponding liability is established. That receivable would need to be assessed for impairment. When no legal or contractual arrangement exists to recover the funded amounts from the co-obligors, the Task Force noted that an entity should consider all relevant facts and circumstances to determine whether the gain contingencies guidance in Subtopic 450-30 or other guidance would apply in recognizing a receivable for potential recoveries.

If the co-obligors are related parties, an entity should consider the reasons for, and substance of, the arrangement among the co-obligors in determining the corresponding entry or entries for any amounts that it has agreed or expects to pay on behalf of its co-obligors. For an amount owed from a shareholder or related party (such as a sister company) to be classified as an asset (a receivable), the terms of the transaction generally should be comparable to the terms that would be expected to be available from external sources (e.g., interest rates, payment terms and maturities, evidence of the ability and intent of repayment, and nature and sufficiency of collateral). If an entity has agreed or expects to pay an amount on behalf of a co-obligor that is a related party and receivable classification is not appropriate, the appropriate corresponding entry might be to equity. For example, if a subsidiary expects to pay an amount on behalf of its parent, the substance of the subsidiary’s payment might be that of an equity distribution from the subsidiary to the parent.

### 7.5.5 Disclosure

**ASC 405-40**

**50-1** An entity shall disclose the following information about each obligation, or each group of similar obligations, resulting from joint and several liability arrangements included in the scope of this Subtopic:

- The nature of the arrangement, including:
  1. How the liability arose
  2. The relationship with other co-obligors
  3. The terms and conditions of the arrangement.
- The total outstanding amount under the arrangement, which shall not be reduced by the effect of any amounts that may be recoverable from other entities
- The carrying amount, if any, of an entity’s liability and the carrying amount of a receivable recognized, if any
- The nature of any recourse provisions that would enable recovery from other entities of the amounts paid, including any limitations on the amounts that might be recovered
- In the period the liability is initially recognized and measured or in a period the measurement changes significantly:
  1. The corresponding entry
  2. Where the entry was recorded in the financial statements.

**50-2** The disclosures required by this Section do not affect the related-party disclosure requirements in Topic 850. The disclosure requirements in this Section are incremental to those requirements.
An entity must disclose information about the nature and amount of each obligation (or each group of similar obligations) within the scope of ASC 405-40, including how the liability arose, the relationship with other co-obligors, and any other relevant terms and conditions of the explicit or implicit agreement between them.

7.6 Convertible Debt

7.6.1 Background
This section briefly summarizes the various accounting models that apply to convertible debt when an entity is not required to bifurcate the conversion feature as a derivative under ASC 815-15 (see Section 8.4.7). Such models include:

- Traditional convertible debt (see Section 7.6.2 below).
- Convertible debt issued at a substantial premium (see Section 7.6.3).
- Convertible debt with cash conversion features (see Section 7.6.4).
- Convertible debt with beneficial conversion features (see Section 7.6.5).

For a comprehensive discussion of these models, see Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

7.6.2 Traditional Convertible Debt

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-10</strong></td>
</tr>
<tr>
<td>The guidance in paragraph 470-20-25-12 addresses debt instruments that have both of the following characteristics:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>b. The debt instrument is sold at a price or has a value at issuance not significantly in excess of the face amount.</td>
</tr>
</tbody>
</table>

| **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.
The issuer of a convertible debt instrument to which ASC 470-20-25-12 applies does not allocate any of the proceeds to equity. Only convertible debt instruments that have the characteristics described in ASC 470-20-05-4 and ASC 470-20-25-10 and 25-11 are eligible for this accounting as a single debt instrument. For example:

- The holder has an option to convert the debt into the common stock of the issuer (or one of its substantive subsidiaries) 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).
- 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.”

Upon the initial recognition of traditional convertible debt, the issuer presents the entire amount attributable to the debt (see Section 3.4) as a liability. If the issuer elects to account for the convertible debt at fair value on a recurring basis under the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4), any issuance costs are expensed at inception (see Section 5.5). 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 5.3). The issuer should also determine whether the instrument contains any embedded features that must be bifurcated as derivatives under ASC 815-15 (e.g., the conversion feature, a put option, a call option, or an interest rate adjustment feature; see Chapter 8).
Example 7-10

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. Further, 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:

| Cash | 8,000,000 |
| Debt | 8,000,000 |

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 attributable to a change in instrument-specific credit risk in OCI (see Section 6.3). 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 (see Section 6.2). Reported interest expense on convertible debt to which ASC 470-20-25-12 applies is generally lower than that 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 GAAP, there are several important exceptions to the prohibition in ASC 470-20-25-12 against separately recognizing a conversion feature embedded in a convertible debt instrument:

- If the conversion feature meets the bifurcation criteria in ASC 815-15 (see Section 8.4.7), it is accounted for separately from the debt host contract as a derivative at fair value, with changes in fair value recognized in earnings.

- If the conversion feature was bifurcated as a derivative but no longer meets the bifurcation criteria, ASC 815-15-35-4 requires the issuer to reclassify the previously bifurcated conversion option into equity (see Section 8.5.4.3).

- If the convertible debt can be settled in full or in part in cash upon conversion, the CCF guidance in ASC 470-20 (see Section 7.6.4) requires the issuer to separate an equity component unless the feature must be bifurcated as a derivative under ASC 815-15 (see Section 8.4.7).

- 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 Section 7.6.5) unless either (1) the conversion feature must be bifurcated as a derivative under ASC 815-15 (see Section 8.4.7) or (2) the convertible debt is subject to the CCF guidance in ASC 470-20 (see Section 7.6.4).

- 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 10.4.3).
• 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 Section 7.6.3 below) unless the conversion feature requires bifurcation as a derivative under ASC 815-15-25-1 (see Section 8.4.7) or an equity component has been separated under the CCF or BCF guidance in ASC 470-20 (see Sections 7.6.4 and 7.6.5, respectively).

For further discussion of the application of ASC 470-20 to traditional convertible debt, see Chapter 4 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

### 7.6.3 Convertible Debt Issued at a Substantial Premium

ASC 470-20

| 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.

Sometimes, convertible debt is sold or initially recognized at a substantial premium over the principal amount to be repaid at maturity. In this circumstance, there is a presumption that the premium should be recognized in equity as paid-in capital if it is substantial.

ASC 470-20-25-13 applies only to convertible debt instruments that are not specifically addressed in other GAAP; therefore, it does not apply to:

- Convertible debt instruments with a conversion feature that must be bifurcated as a derivative under ASC 815-15 (see Section 8.4.7).
- Convertible debt instruments that have a separated equity component under the CCF or BCF guidance in ASC 470-20 (see Sections 7.6.4 and 7.6.5).

Further, ASC 470-20-25-13 does not apply if the conversion feature economically represents a share-settled redemption feature (see Section 8.4.7.2.5).

The guidance on allocating a substantial premium to paid-in capital may apply in circumstances in which, for example:

- 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.

While ASC 470-20 does not define substantial, in practice, a premium of 10 percent or more is considered substantial. 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).
Although ASC 470-20 does not specifically address such cases, an entity may be able to overcome the presumption that it should record a substantial premium in APIC if the premium is not attributable to the value of the equity conversion feature. For example, the presumption may be overcome if:

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

When convertible debt is initially recognized under ASC 470-20-25-13, the principal amount of the debt is recognized as a liability, and the premium is recognized in APIC. The issuer should also determine whether the instrument contains any other embedded features that must be bifurcated as derivatives under ASC 815-15 (e.g., a put, call, redemption, or indexation feature; see Chapter 8). While the issuer should reduce the initial carrying amount of the convertible debt by any direct or incremental issuance costs paid to third parties that are 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).

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 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4). 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 (see Section 6.2). The issuer would not subsequently remeasure the amount initially recognized for the premium in equity.

For further discussion of the application of ASC 470-20 to convertible debt issued at a substantial premium, see Chapter 5 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt.

Example 7-11

Assumption of Convertible Debt in a Business Combination

Entity A acquires Entity B and assumes B’s outstanding convertible debt. 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 7-12

**Liability-Classified Physically Settled 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:

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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100</td>
</tr>
<tr>
<td>Warrant Liability</td>
<td>105</td>
</tr>
<tr>
<td>Convertible Debt</td>
<td>100</td>
</tr>
<tr>
<td>Additional Paid-in Capital</td>
<td>105(^5)</td>
</tr>
</tbody>
</table>

\(^5\) [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.

7.6.4 Debt With a CCF

7.6.4.1 Background

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>05-13 The Cash Conversion Subsections address certain convertible debt instruments that may be settled in cash upon conversion . . . .</td>
</tr>
<tr>
<td>15-4 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 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 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>
</tbody>
</table>

A debt 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 EITF Issue 90-19 (superseded), three variants of convertible bonds with CCFs were identified (Instruments A, B, and C), and at the 2003 AICPA Conference
on Current SEC Developments, 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>Instrument B</td>
<td>Issuer option to elect either cash or physical share settlement</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>Instrument X</td>
<td>Combination settlement</td>
</tr>
</tbody>
</table>

**Example 7-13**

**Variants of Convertible Debt With a 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, 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 $1.25 million (10,000 shares × $125).</td>
</tr>
<tr>
<td>Instrument B</td>
<td>The issuer can elect to either deliver 10,000 equity shares or pay cash of $1.25 million (10,000 shares × $125).</td>
</tr>
<tr>
<td>Instrument C</td>
<td>The issuer must pay $1 million 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 $1.25 million (e.g., 1,000 shares and $1.125 million of cash).</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.
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. The issuer accomplishes this by allocating the amounts received as follows (see Section 7.6.4.3 below):

- **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 (see Section 7.6.4.4). Since any debt discounts or premiums are amortized to earnings, the reported interest cost includes the implicit interest cost that was “paid” through the inclusion of a conversion option in the instrument.

### 7.6.4.2 Scope

The issuer of convertible debt should evaluate whether the CCF guidance in ASC 470-20 applies. Under that guidance, a convertible debt instrument must meet 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 does not need to be separately accounted for as a derivative instrument under ASC 815-15 (see Section 8.4.7).

Convertible debt in the form of Instrument B, C, or X (see Section 7.6.4.1) is within the scope of the CCF guidance in ASC 470-20 unless the conversion option is separated as a derivative under ASC 815-15. Convertible debt in the form of Instrument A is not within the scope of the CCF guidance in ASC 470-20 because the conversion option must be bifurcated as a derivative. Further, the CCF guidance in ASC 470-20 does not apply if the conversion feature economically represents a share-settled redemption feature (see Section 8.4.7.2.5).

For a more detailed discussion of the scope of the CCF guidance in ASC 470-20, including its application to certain mandatorily redeemable preferred stock and specific scope exceptions, see Section 6.2 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

### 7.6.4.3 Initial Accounting

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-22</strong> 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.</td>
</tr>
</tbody>
</table>

<p>| |</p>
<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-23</strong> The issuer of a convertible debt instrument within the scope of the Cash Conversion Subsections shall do both of the following:</td>
</tr>
<tr>
<td>- First, determine the carrying amount of the liability component in accordance with the guidance in paragraph 470-20-30-27.</td>
</tr>
<tr>
<td>- 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.</td>
</tr>
</tbody>
</table>
25-25 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.

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.

30-28 The carrying amount of the equity component represented by the embedded conversion option shall be determined for purposes of paragraph 470-20-25-23 by deducting the fair value of the liability component from the initial proceeds ascribed to the convertible debt instrument as a whole.

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 under which it performs the following steps:

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 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt).

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 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt).

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 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt).

As noted above, 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. 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, including any substantive embedded put or call options embedded in the instrument irrespective of whether they must be bifurcated under ASC 815-15.
The equity component is recognized at the residual amount determined by deducting (1) the amount allocated to the liability component from (2) the initial proceeds attributable to the convertible debt. Further, an adjustment is made to the initial carrying amount for any transaction costs allocable to the equity component.

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 (see Section 3.5.3.4).

If any feature other than the conversion feature must be bifurcated as an embedded derivative (e.g., an embedded put or call option), the feature 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.

For a more detailed discussion of the initial accounting guidance for debt within the scope of the CCF guidance in ASC 470-20, including the evaluation of whether a feature is nonsubstantive, and the application of income approaches for determining the initial fair value of the liability component, see Section 6.3 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

### 7.6.4.4 Subsequent Accounting

**ASC 470-20**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>10-1</td>
<td>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>
<tr>
<td>35-12</td>
<td>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>35-17</td>
<td>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>
</tbody>
</table>

After initial recognition, the issuer measures the liability component of the convertible debt at amortized cost by applying the interest method in ASC 835. ASC 470-20 includes special amortization guidance on the debt discount that is created by the separation of the liability component (see Section 6.2.4.6).

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.

For a more detailed discussion of the subsequent accounting for debt within the scope of the CCF guidance in ASC 470-20, see Section 6.4 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*. 
7.6.4.5 **Reclassification**

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-18 A reclassification of the equity component (conversion option) would not affect the accounting for the liability component.</td>
</tr>
<tr>
<td>35-19 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>35-20 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>

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; see Deloitte's *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*), the issuer reclassifies the previously recognized equity component as a liability (see also *Section 8.5.4.2*). The liability and equity components of the convertible debt instrument are not recombined; instead, they 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.

7.6.5 **Debt With a BCF**

7.6.5.1 **Background**

A BCF is an equity conversion feature that is beneficial to the holder on its commitment date. The issuer of debt with a BCF should evaluate whether the debt is within the scope of the BCF guidance in ASC 470-20.

7.6.5.2 **Scope**

<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>

The BCF guidance in ASC 470-20 applies to the issuer’s accounting for debt instruments that contain an equity conversion feature that is in-the-money on its commitment date. The BCF guidance does not apply if (1) the conversion feature must be bifurcated as an embedded derivative under ASC 815 (see *Section 8.4.7*), (2) the debt is within the scope of the cash conversion guidance in ASC 470-20 (see *Section 7.6.4*), or (3) the conversion feature economically represents a share-settled redemption feature (see *Section 8.4.7.2.5*). For a more detailed discussion of the scope of the BCF guidance in ASC 470-20, including its application to convertible preferred stock and interaction with the fair value option requirements in ASC 825-10, see *Section 7.2* of Deloitte's *A Roadmap to the Issuer’s Accounting for Convertible Debt*. 
### 7.6.5.3 Initial Accounting

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-5</strong> 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. . .</td>
</tr>
<tr>
<td><strong>30-3</strong> An embedded beneficial conversion feature recognized separately under paragraph 470-20-25-5 shall be measured initially at its intrinsic value.</td>
</tr>
<tr>
<td><strong>30-6</strong> 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.</td>
</tr>
</tbody>
</table>

To determine whether a BCF exists and, if so, to measure it, an issuer should calculate the conversion feature's intrinsic value, if any. This calculation 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 of Deloitte's *A Roadmap to the Issuer's Accounting for Convertible Debt*). Under ASC 470-20-30-12, the commitment date is the earlier of the issuance date and the date on which 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.

- The instrument's effective conversion price (see Section 7.3.2.2 of Deloitte's *A Roadmap to the Issuer's Accounting for Convertible Debt*), which depends on the amount of proceeds allocated to the instrument and the number of shares it is convertible into. Often, the effective conversion price differs from the stated conversion price because the instrument was issued at an amount that is different from its principal amount (i.e., at a discount or premium) or was issued together with other detachable financial instruments.

The intrinsic value of a BCF is calculated as the product of (1) the excess 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. Because the effective conversion price equals the proceeds allocated to the instrument divided by the number of shares to be issued upon conversion, an alternative method of determining the intrinsic value is to calculate the excess of (1) the initial fair value of the instruments into which the instrument is convertible over (2) the amount of proceeds allocated to the instrument. The intrinsic value calculated under either method is the same.

In computing the effective conversion price of a convertible debt instrument (or the proceeds used to calculate the intrinsic value under the second method above), 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. In addition, 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 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 allocated to the convertible debt instrument include any proceeds attributed to embedded derivatives that are accounted for separately under ASC 815-15.

**Example 7-14**

**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>Account</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.

**Example 7-15**

**Calculation of Intrinsic Value — Convertible Debt Issued With Detachable Warrants**

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 3.4.2).

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) × 10,000].

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>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>
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. 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 (see Section 7.6.5.5).

For a comprehensive discussion of the initial recognition and measurement of BCF features, including
the treatment of PIK provisions, see Section 7.3 of Deloitte’s A Roadmap to the Issuer’s Accounting for
Convertible Debt.

7.6.5.4 Subsequent Accounting

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-7</strong> 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: . . .</td>
</tr>
<tr>
<td>2. For convertible debt securities, that discount shall be recognized as interest expense using the effective yield method.</td>
</tr>
</tbody>
</table>

The recognition of a BCF creates a discount (or reduced premium) on the convertible debt liability. This
discount is amortized to interest expense in accordance with the interest method (see Section 6.2). The
amortization method will depend on whether the instrument has a stated redemption date or involves a
multiple-step discount (see Section 6.2.4.7).

For more detail about the subsequent accounting for BCFs, see Section 7.4 of Deloitte’s A Roadmap to
the Issuer’s Accounting for Convertible Debt.

7.6.5.5 Contingent BCFs

<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>35-2</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>
<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>
</tbody>
</table>
Often, the terms of convertible debt instruments contain conversion features that (1) are 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) specify contingent adjustments to the conversion price. Such features represent contingent BCFs if the conversion price that would apply if the contingent feature is triggered is in-the-money on the basis of the commitment-date stock price. 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.

**Example 7-16**

**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>

On the date the contingent BCF is triggered, the journal entry is as follows:

<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>

Some 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 (see Section 7.5.1.1 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*), it does not represent a contingent BCF because it does not give the holder any additional benefit or value.

If it is known at inception how many incremental shares would be issued upon conversion if the contingency is met, 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 over the new effective conversion price by (2) the number of shares into which the instrument is convertible under the new circumstances. If a BCF was previously recognized, the adjustment on the date on which the contingent BCF is triggered must take into account the previously recognized BCF. If 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), the issuer computes the intrinsic value on the basis of the number of shares it will deliver once that amount is known (see Section 7.5.3.2 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*).

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 on which 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.
For a comprehensive discussion of the accounting for contingent BCF features, see Section 7.5 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

### 7.6.5.6 Reclassification

If the conversion feature no longer meets the equity classification conditions in ASC 815-40 (see Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*), the issuer should recognize a derivative liability for the conversion feature at its fair value as of the date it ceases to meet the equity classification conditions (see Sections 8.5.2 and 8.5.4). Further, the issuer should account for the reacquisition of the BCF on the basis of the amount that was allocated to the BCF when the debt was first issued (i.e., the entire balance of the previously recorded APIC for the BCF is eliminated). For further discussion, see Section 7.6.5 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

### 7.6.6 Temporary Equity

<table>
<thead>
<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</td>
</tr>
<tr>
<td>S99-3A</td>
</tr>
<tr>
<td>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.”</td>
</tr>
<tr>
<td>3(e). <em>Convertible debt instruments that contain a separately classified equity component.</em> Other applicable GAAP may require a convertible debt instrument to be separated into a liability component and an equity component.[FN8] 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.</td>
</tr>
<tr>
<td>12. <em>Initial measurement.</em> 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: . . .</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
ASC 480-10 — SEC Materials — SEC Staff Guidance (continued)

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.\textsuperscript{FN15}

\textsuperscript{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.

23. Convertible debt instruments that contain a separately classified equity component. For convertible debt instruments subject to ASR 268 (see paragraph 3(e)), there should be no incremental earnings per share accounting from the application of this SEC staff announcement. Subtopic 260-10 addresses the earnings per share accounting.

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 (see Section 7.6.4).
- Convertible debt instruments that contain a separately recognized BCF (see Section 7.6.5).
- 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 Section 10.4.3).
- Convertible debt instruments that contain a separately recognized equity component as a result of the reclassification of a previously bifurcated embedded conversion feature (see Section 8.5.4.3).

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. Thus, the guidance does not apply in 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 

\[(1) \text{ the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion} \ldots \text{over} \ (2) \text{ the carrying amount of the liability-classified component of the convertible debt instrument}\]

both at initial measurement and on subsequent balance sheet dates.

For a comprehensive discussion of the SEC's temporary equity guidance, see Chapter 9 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*.

**Example 7-17**

**Convertible Debt With 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 (1) the put option was nonsubstantive (i.e., its exercise was not probable; see Section 6.3.2.2 of Deloitte's *A Roadmap to the Issuer's Accounting for Convertible Debt*) and (2) it was not required to bifurcate the put option and account for it 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.

**7.7 Debt Exchangeable Into the Stock of Another Entity**

**ASC 470-20 — SEC Materials — SEC Staff Guidance**

*Comments Made by SEC Observer at Emerging Issues Task Force (EITF) Meetings*

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 convertible 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 the issuer's equity shares ("exchangeable debt"). For example, the terms of a debt instrument may include an option for the holder to require the issuer to deliver a fixed number of shares of common stock of a third party in lieu of repaying the debt's principal amount at maturity. From the issuer's perspective, exchangeable debt is substantially different from convertible debt because the embedded exchange feature is not settled in the issuer's equity shares but in third-party stock.

In EITF Issue 85-9 (superseded), the SEC staff observer indicated that “he believes that [ASC 470-20-25-12] does not apply and that separation of the debt element and the exchangeability feature is required.” After the publication of Issue 85-9, the FASB issued Statement 133 (codified in ASC 815). The status section of EITF Issue 85-9 notes that a "nondetachable (thus embedded) warrant to exchange debt into another entity's stock is not clearly and closely related to the debt instrument and, if it meets the definition of a derivative, shall be separated from the debt and accounted for as a derivative instrument."

Accordingly, the issuer of exchangeable debt should not analyze such debt as convertible debt under ASC 470-20. Instead the issuer should evaluate whether the exchange feature must be separated as a derivative under ASC 815-15 (see Section 8.4.7) and, if not, whether the SEC staff observer comments in ASC 470-20-S99-1 apply. Under ASC 470-20-S99-1, the exchange feature would be accounted for separately from the debt even if it is not required to be separated as a derivative under ASC 815 (e.g., the feature might not need to be separated as a derivative if it does not meet the net settlement characteristic in the definition of a derivative; see Section 8.4.7).

ASC 470-20-S99-1 does not address the measurement of an exchange feature that does not have to be accounted for as a derivative. An entity might analogize to the guidance on embedded features that are accounted for as derivatives and account for the exchange feature at fair value, with changes in fair value recognized in net income. Alternatively, an entity might look to the indexed-debt guidance in ASC 470-10 and account for the exchange feature on the basis of an intrinsic value approach under which changes in intrinsic value are recognized in net income. Under that approach, the exchange feature is measured on the basis of the excess, if any, of the current value of the third-party stock over the debt's net carrying amount, without regard to the time value inherent in the option to exchange the debt for third-party stock (see Section 7.4.5).

In consolidated financial statements, a contract exchangeable into the equity shares of a consolidated subsidiary is analyzed in a manner similar to a contract 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 the case irrespective of whether the debt instrument is issued by the parent or subsidiary. Accordingly, if a parent issues a debt instrument that is exchangeable into the equity shares of a consolidated subsidiary and the subsidiary is a substantive entity, the exchange feature would be analyzed as a conversion feature under ASC 470-20 unless it has to be accounted for as a derivative instrument under ASC 815 (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). Equity shares issued by an equity-method investee, however, are not considered part of the entity's own equity.

In the subsidiary's separate financial statements, the equity of its parent 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 in a manner similar to a contract that is convertible into the subsidiary's equity shares 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.
Chapter 8 — Embedded Derivatives

8.1 Background

<table>
<thead>
<tr>
<th>ASC 815-15</th>
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**05-1** Contracts that do not in their entirety meet the definition of a derivative instrument (see paragraphs 815-10-15-83 through 15-139), such as bonds, insurance policies, and leases, may contain embedded derivatives. The effect of embedding a derivative instrument in another type of contract (the host contract) is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent on the occurrence of a specified event, will be modified based on one or more underlyings.

**15-2** The guidance in this Subtopic applies only to contracts that do not meet the definition of a derivative instrument in their entirety.

Although outstanding debt instruments typically do not meet the definition of a derivative in their entirety (e.g., they usually lack a derivative’s initial net investment characteristic; see Section 8.3.4.3), the contractual terms of debt arrangements may include one or more embedded features that could affect the cash flows, values, or other exchanges required by the terms in a manner similar to a derivative. An entity is required to evaluate such features to determine whether they must be accounted for separately from their host debt contract as derivative instruments under ASC 815 (see Section 8.4).

In developing the derivative accounting requirements that are now located in ASC 815 (such as the requirement to measure derivatives at fair value on a recurring basis), the FASB concluded that an entity should not be able to circumvent those requirements by incorporating derivatives in the contractual terms of nonderivative contracts (e.g., outstanding debt). Accordingly, it decided that derivatives that are embedded in the terms of nonderivative contracts should be accounted for as derivatives separately from the contracts in which they are embedded when certain criteria are met. An entity is thus unable to avoid the recognition and measurement requirements of ASC 815 merely by embedding a derivative instrument in a nonderivative financial instrument or other contract.

The FASB also decided that not all embedded features that would have been accounted for as a derivative if they had been transacted on a freestanding basis would need to be bifurcated from their host contracts. Only features that would have met the definition of a derivative in ASC 815 on a freestanding basis (see Section 8.3.4) and for which no scope exception from derivative accounting applies (see Section 8.3.5) should be bifurcated. Features that are embedded in contracts that are accounted for in their entirety at fair value, with changes in fair value recognized in earnings on a recurring basis, are also not bifurcated (see Section 8.3.3). Further, features that have economic characteristics and risks that are clearly and closely related to those of their host contract are not bifurcated.
Accordingly, a debtor must carefully evaluate the terms of outstanding debt arrangements to determine whether they contain any features that must be accounted for as derivatives separately from their debt host contracts under ASC 815-15. Examples of such terms include:

- Indexed principal or interest payments (e.g., to benchmark interest rates, credit spreads, inflation rates, equity prices, commodity prices, revenues, or other underlyings; see Sections 8.4.1, 8.4.2, 8.4.3, 8.4.7, 8.4.9, and 8.4.10).
- Interest payments that are leveraged or inversely related to market interest rates or are subject to a collar, cap, or floor (see Section 8.4.1).
- The holder’s right to require the issuer to repay the outstanding amount before the stated maturity date (i.e., a put or redemption option; see Section 8.4.4).
- The issuer’s right to prepay the stated amount (i.e., a call option; see Section 8.4.4).
- Terms that accelerate the repayment of principal or interest upon the occurrence or nonoccurrence of an event (e.g., an event of default, a change of control, or an IPO; see Section 8.4.4).
- Term extension features (see Section 8.4.5).
- A right or obligation to convert the instrument into the debtor’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 IPO; see Section 8.4.7).
- Foreign currency features (see Section 8.4.8).
- 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 (e.g., late filings; See Section 8.4.11.)

This chapter provides an overview of the derivative separation requirements that apply to embedded features in debt instruments.

### 8.2 Identification of Embedded Features

#### 8.2.1 General

| ASC 815-15 — Glossary
<table>
<thead>
<tr>
<th></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>
<tr>
<td><strong>Hybrid Instrument</strong></td>
</tr>
<tr>
<td>A contract that embodies both an embedded derivative and a host contract.</td>
</tr>
</tbody>
</table>

A contract that does not in its entirety meet the definition of a derivative (e.g., outstanding debt) may contain one or more embedded features that would have met the definition of a derivative (see Section 8.3.4) if they had been transacted on a stand-alone basis. ASC 815 describes a contract that contains an embedded derivative as a “hybrid instrument.” For example, debt with an equity conversion feature is a hybrid instrument. The contract in which such a feature is embedded is the host contract.
Features that are legally detachable and separately exercisable from a financial instrument represent freestanding financial instruments; therefore, they are not evaluated as embedded derivatives even if they are contractually part of the same contract (e.g., a freestanding warrant or loan commitment that is issued as part of the contractual terms of a debt instrument). Such features are treated as separate units of account since they meet the definition of a freestanding financial instrument (see Section 3.3).

8.2.2 Payoff-Profile Approach to Identifying Embedded Derivatives

To identify embedded derivatives, an entity should not rely solely on how terms are described in the contractual provisions of a debt instrument; rather, the entity should consider the economic payoff profile of the contractual terms. Under the payoff-profile approach, the embedded features in a hybrid instrument are identified on the basis of the monetary or economic value that each feature conveys upon settlement (e.g., a feature that settles at a fixed monetary amount is evaluated separately from a feature that settles at an amount indexed to a specified underlying, such as the debtor's stock price). Embedded features with different payoff profiles are evaluated separately. The payoff-profile approach to identifying embedded features 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.

If an embedded feature's economic payoff profile differs from how the provision is described in the instrument's contractual terms, an entity must evaluate the feature on the basis of its payoff profile, not its contractual form (see Section 3.2). For example, a term that is described as a conversion feature would be evaluated as a redemption feature if, upon exercise, it represents a right for the investor to receive a variable number of equity shares worth a fixed monetary amount (see also Section 8.4.7.2.5). Further, the contractual conversion terms of a debt instrument might need to be separated into multiple features on the basis of the nature of the payoff. For instance, depending on the circumstances at conversion or the types of events that could trigger a conversion, such terms might specify the delivery of either (1) a variable number of the issuer's equity shares with an aggregate fair value at settlement equal to a fixed monetary amount (a share-settled redemption feature) or (2) a fixed number of the issuer's equity shares (an equity conversion feature). It is therefore appropriate to separate the stated conversion terms into a redemption feature and an equity conversion feature even though they are described in the same contractual conversion provision.

Different terms within a debt instrument that have the same economic payoff profile may need to be evaluated on a combined basis even if they involve different forms of settlement. For example, a convertible debt instrument might contain provisions related to the redemption and conversion of the instrument in separate sections of the debt indenture. If triggered, the redemption provisions require settlement at an amount of cash equal to the greater of a fixed monetary amount and the fair value of a fixed number of the debtor's equity shares. The conversion provisions require settlement in a fixed number of the debtor's equity shares. In this example, the requirement to potentially redeem the debt for cash at an amount equal to the fair value of a fixed number of equity shares would be analyzed as a part of the equity conversion feature (not as part of the redemption feature). The requirement to potentially redeem the debt for cash at a fixed monetary amount would be evaluated as a redemption feature.

Under the payoff-profile approach, an equity conversion feature (see Section 8.4.7.2.2) generally is evaluated as a single embedded feature even if it contains multiple exercise contingencies. The equity conversion feature would not be split into embedded features for each of the exercise contingencies if the payoff is similar for each of the exercise contingencies. For example, a conversion feature that would result in the delivery of a fixed number of the issuer's equity shares upon exercise might be exercisable in multiple circumstances, such as if the instrument trades at a price below 98 percent of
par, the common stock trades at a price in excess of 120 percent of par, the issuer elects to call the
debt, or specified corporate transactions take place. Such a conversion feature would be analyzed as
one embedded conversion feature, not as multiple conversion features.

Other features that have an interdependent payoff are evaluated on a combined basis as a single
embedded feature. For example, a debt instrument may contain multiple additional interest provisions
that specify a fixed increase to the interest rate (e.g., 0.25 percent or 0.50 percent) upon the occurrence
of any of a number of specified events (e.g., an event of default involving the debtor, the debtor's late
submission of its SEC filings, or the holder's inability to freely trade the instrument; see Section 8.4.11). If
there is a contractual ceiling on the total amount of additional interest that the debtor could be required
to pay under all of the additional interest provisions, each such additional interest provision would be
interdependent, because no incremental amount would be payable once the ceiling is reached even if
an event that otherwise would trigger an additional interest payment were to occur. Accordingly, those
additional interest provisions would be evaluated on a combined basis as one embedded interest
feature. If any of the underlying events that would trigger additional interest payments is not clearly
and closely related to the debt host, the combined additional interest feature would not be clearly and
closely related to the debt host even if additional interest provisions individually would have been clearly
and closely related to the debt host. However, if additional interest provisions are independent (i.e.,
they are additive), it may be appropriate to evaluate each one separately. That is, the determination of
whether an embedded derivative must be bifurcated might differ for each individual additional interest
feature depending on what triggers it.

**Connecting the Dots**
Callable debt may contain a provision that requires the debtor to pay a premium to the
holder if it were to call the debt before its maturity. Such a provision might be called a “make-
whole provision,” a “change in control make-whole,” a “maintenance premium payment,” a
“maintenance call,” or a “lump-sum call payment.” Regardless of its label, the feature would
require the debtor, upon exercise of the feature's call option, to make a lump-sum payment
to the investor as compensation for future interest payments that will not be paid because of
the shortening of the outstanding life of the instrument (e.g., the present value of the debt's
remaining interest cash flows, discounted at a small spread over the then-current U.S. Treasury
rate). When an interest make-whole provision is triggered by the exercise of a call option, the
make-whole provision is considered an integral component of the call option; it is not a distinct
embedded feature that must be separately evaluated under ASC 815-15. See Section 8.4.4 for
further discussion of the evaluation of embedded call options.

**Example 8-1**

**Loan With Interest That Varies on the Basis of the Issuer's Stock Market Capitalization**

Company A entered into a loan agreement that contains variable interest payments. The interest rate on the
loan is defined as a market-based variable component (e.g., LIBOR) plus an applicable margin. The applicable
margin varies on the basis of the issuer's stock market capitalization, as follows:

<table>
<thead>
<tr>
<th>Market Capitalization</th>
<th>Applicable Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than or equal to $10 billion</td>
<td>5.55%</td>
</tr>
<tr>
<td>Greater than $10 billion but less than or equal to $15 billion</td>
<td>5.20%</td>
</tr>
<tr>
<td>Greater than $15 billion</td>
<td>4.85%</td>
</tr>
</tbody>
</table>
Example 8-1 (continued)

Because the applicable margin is additive to the variable base rate, the issuer may identify it as an embedded feature that is separate from the variable base rate. Under this view, there are two embedded features: (1) the variable base rate and (2) the applicable margin. The variable base rate is evaluated under ASC 815-15-25-26 because it is based solely on interest rates (see Section 8.4.1). The applicable margin is indexed to the issuer’s stock market capitalization, which is an underlying other than an interest rate or interest rate index (see Section 8.4.1), the debtor’s creditworthiness (see Section 8.4.2), or inflation (see Section 8.4.3). Accordingly, this feature should not be evaluated under ASC 815-15-25-26. It would be considered not clearly and closely related to the debt host (see Section 8.4.7).

An entity is not permitted to identify embedded features that are not clearly present in the hybrid instrument. For example, an entity is not permitted to disaggregate a fixed-rate debt instrument into (1) a floating-rate debt instrument and (2) an embedded interest rate swap that exchanges floating interest payments for fixed interest payments.

8.2.3 Illustration of the Identification of Embedded Features

Example 8-2

Convertible Promissory Note With Various Embedded Features

During the fiscal year ended December 31, 20X3, Entity X issued $20 million of convertible promissory notes with the following terms:

- Interest — The notes carry a fixed rate of interest of 1 percent per annum.
- Maturity date — The notes mature on the earlier of (1) June 30, 20X8, or (2) the date on which, upon the occurrence (and during the continuance) of an event of default, such amounts are declared due and payable by an investor or become automatically due and payable (see below).
- Mandatory prepayment — In the event of a change of control of X, the outstanding principal amount of the notes and all accrued and unpaid interest on them are due and payable immediately before the closing of such change of control.
- Automatic conversion — If X sells shares of its capital stock for aggregate gross proceeds of at least $40 million (a “qualified financing”) before the maturity date, the outstanding principal amount of the notes and all accrued and unpaid interest on them automatically convert into shares issued in such qualified financing at a price equal to the lesser of (1) the price per share paid by investors in the qualified financing and (2) the quotient of $25 million and the amount of X’s fully diluted equity capital.
- Voluntary conversion — Upon the election of a majority of the investors, the outstanding principal amount of the notes and all accrued and unpaid interest on them may be converted into shares of X’s capital stock issued in any equity financing for capital raising purposes at a price equal to the lesser of (1) the price per share paid by investors in such financing and (2) the quotient of $25 million and the amount of X’s fully diluted equity capital. If no qualified financing occurs on or before the maturity date, a majority of the investors can elect to convert the outstanding principal amount of the notes and all accrued and unpaid interest on them into shares of X’s preferred stock at a price per share equal to the quotient of $25 million and the amount of X’s fully diluted equity capital.
- Conversion upon a change of control — If a change of control occurs before a qualified financing, the investors may elect to convert the outstanding principal amount of the notes and all accrued and unpaid interest on the notes immediately before such change of control into shares of X’s common stock at a price per share equal to the quotient of $25 million and the amount of X’s fully diluted equity capital.
- Revenue-based payment feature — Entity X is required to make payments of up to $1 million each quarter based on 10 percent of all revenue over $10 million.
• **Rights of investors upon default** — Upon the occurrence of an event of default (other than an event of default involving voluntary or involuntary bankruptcy or insolvency proceedings) and at any time thereafter during the continuance of such an event of default, a majority of the investors may elect to declare all outstanding obligations under the notes to be immediately due and payable. Upon the occurrence of any event of default involving voluntary or involuntary bankruptcy or insolvency proceedings, immediately and without notice, all outstanding obligations under the notes automatically become immediately due and payable. Investors also have the right to receive additional interest on the notes at a rate equal to 1 percent per annum of the principal amount of the notes outstanding for each day during the first 180 days after the occurrence of an event of default and 2 percent per annum of the principal amount of the notes outstanding from the 181st day following the occurrence of an event of default. All events of default represent credit-risk-related covenants (see Section 8.4.2.3).

Entity X is evaluating whether any embedded features must be separated from the notes and accounted for as derivatives under ASC 815-15. It has determined that the notes should be analyzed as a debt host contract under ASC 815-15 (see Section 8.3.2). Under the payoff-profile approach, the notes contain the following embedded features that should be evaluated under ASC 815-15:

• **Contingent redemption features** — The features below involve the contingent settlement of the notes for consideration of the same fixed monetary amount. Because each feature is contingent and settleable for the same monetary amount, X analyzes them as one combined embedded feature:

  ○ If a qualified financing occurs before the maturity date, the outstanding principal amount of the notes and all accrued and unpaid interest on them automatically convert into shares of the capital stock issued in the qualified financing at a price no higher than the price paid per share by its investors in the qualified financing. Although this feature is settled in shares, the number of shares delivered under the feature varies on the basis of the fair value of those shares (i.e., price per share paid by the investors) so that the total fair value of those shares will equal the outstanding principal amount and accrued and unpaid interest on the notes regardless of changes in the fair value of the shares. Accordingly, this feature is effectively an early redemption of the notes that uses shares as “currency.” Entity X therefore analyzes it as a redemption feature under the monetary payoff profile approach (see Section 8.4.7.2.5).

  ○ Upon the election of a majority of the investors, the outstanding principal amount of the notes and all accrued and unpaid interest on them may be converted into shares of X's capital stock issued in any equity financing for capital raising purposes at a price no higher than the price per share paid by investors in such financing. Although this feature is settled in shares, the number of shares that may ultimately be delivered will vary on the basis of the fair value of those shares (i.e., price per share paid by the investors), such that the total fair value of those shares will equal the outstanding principal amount and accrued and unpaid interest of the notes regardless of changes in the fair value of the shares. Accordingly, this feature is effectively an early redemption of the notes that uses shares as “currency.” Entity X therefore analyzes it as a redemption feature under the monetary payoff profile approach (see also Section 8.4.7.2.5).

  ○ In the event of a change of control, the outstanding principal amount of each note that has not otherwise been converted into equity securities, plus all accrued and unpaid interest, is due and payable immediately before the closing of the change of control.

  ○ Upon the occurrence of an event of default and at any time thereafter during the continuance of such event, a majority of the investors may declare all outstanding obligations payable by X under the notes to be immediately due and payable, and such amounts automatically become due upon the occurrence of a voluntary or involuntary bankruptcy or insolvency proceeding of X.
Example 8-2 (continued)

- **Equity conversion feature** — The following features have an equity-based return through conversion of the notes into X's equity shares at a conversion price equal to the quotient of $25 million and the amount of X's fully diluted equity capital:
  - If a qualified financing occurs before the maturity date, the outstanding principal amount of the notes and all accrued and unpaid interest on the notes automatically converts into shares of the capital stock issued in the qualified financing at a price no higher than the quotient of $25 million and the amount of X's fully diluted equity capital.
  - Upon the election of a majority of the investors, the outstanding principal amount of the notes and all accrued and unpaid interest on the notes may be converted into shares of X's capital stock issued in any equity financing for capital raising purposes at a price no higher than the quotient of $25 million and the amount of X's fully diluted equity capital.
  - If a qualified financing does not occur before the maturity date, the outstanding principal amount of the notes and all accrued and unpaid interest on them may be converted at the option of a majority of the investors into shares of X's preferred stock at a price equal to the quotient of $25 million and the amount of X's fully diluted equity capital.
  - If a change of control occurs before a qualified financing, the investors may elect to convert the outstanding principal amount of the notes and all accrued and unpaid interest on them immediately before such change of control into shares of X's common stock at a price per share equal to the quotient of $25 million and the amount of X's fully diluted equity capital.

- **Credit-sensitive payments** — The right to receive additional interest on the notes at a rate equal to 1 percent per annum of the principal amount of the notes outstanding for each day during the first 180 days after the occurrence of an event of default and 2 percent per annum of the principal amount of the notes outstanding from the 181st day following the occurrence of an event of default represents an additional interest provision on the basis of a credit-related feature.

- **Revenue-based payment feature** — The requirement to make payments of up to $1 million each quarter based on 10 percent of all revenue over $10 million is an additional interest provision on the basis of a revenue feature.

8.2.4 Embedded Features in Convertible Debt With a Separately Recognized Equity Component

**ASC 815-15**

55-76A The following steps specify how an issuer shall apply the guidance on accounting for embedded derivatives in this Subtopic to a convertible debt instrument within the scope of the Cash Conversion Subsections of Subtopic 470-20.

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.
As indicated in ASC 470-20, the separation of an equity component does not affect the determination of whether an embedded feature in convertible debt that is subject to the CCF guidance in ASC 470-20 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 an equity component as having created a discount to the liability component. 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 (see Section 8.4.4). 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. 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.

If any feature other than the conversion feature must 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 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.

### 8.3 Bifurcation Criteria

#### 8.3.1 Overall Framework

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-1</strong> 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:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.)</td>
</tr>
</tbody>
</table>

Once an entity has identified the embedded features that require evaluation, it should determine whether those features must be accounted for separately as a derivative. Under ASC 815-15-25-1, an entity is required to separately account for a feature embedded within another contract (the host contract) when all of 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 (see Section 8.3.2). 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 (see Section 8.4.7.3).
- 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 in ASC 815-15 or ASC 825-10; see Section 8.3.3).
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 both (1) the definition of a derivative in ASC 815-10 (see Section 8.3.4) and (2) the scope exceptions from derivative accounting in ASC 815-10 and ASC 815-15 (see Section 8.3.5).

There is no requirement to evaluate the bifurcation conditions in any particular order. Because all three conditions must be met, the analysis ends if any one condition is not satisfied. For example:

- If the hybrid instrument is accounted for at fair value, with changes in fair value recognized in earnings, the entity does not need to identify potential embedded derivatives and can omit an evaluation of whether any embedded features (1) are clearly and closely related to the host contract or (2) would have been accounted for as derivatives if they were freestanding contracts.
- If an embedded feature is clearly and closely related to its host contract, an evaluation of whether it meets the definition of a derivative is not required.
- If an embedded feature does not meet the definition of a derivative (e.g., it does not satisfy the net settlement characteristic in the definition of a derivative), it is unnecessary to evaluate whether it (1) is subject to any scope exception related to derivative accounting or (2) is clearly and closely related to its host contract since the feature would not be bifurcated as a derivative.
- If the feature is subject to a derivative scope exception, the entity can omit an evaluation of whether the feature is clearly and closely related to its host contract since bifurcation as a derivative is prohibited.

8.3.2 Condition 1 — Not Clearly and Closely Related

8.3.2.1 Background

ASC 815-15

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. . . .
identify the economic characteristics and risks of the embedded feature. The manner in which an entity determines the nature of the host contract depends on whether the hybrid contract is in the legal form of debt (see Section 8.3.2.2 below) or an outstanding share (see Section 8.3.2.3 below).

### 8.3.2.2 Hybrid Contracts in the Legal Form of Debt

If the hybrid instrument is in the legal form of debt (i.e., the holder has creditor rights), the host contract is considered to have the economic characteristics and risks of a debt instrument.

Although a hybrid instrument may include embedded features that have the economic characteristics and risks of an equity instrument (e.g., a dividend participation right or a payment feature based on the entity’s stock price), the host contract would nevertheless be considered a debt instrument if the legal form of the hybrid instrument is debt.

For hybrid instruments with debt host contracts, the entity must identify the terms of such debt host. The terms of a debt host contract are identified on the basis of the stated or implied substantive terms of the hybrid instrument (e.g., a fixed rate, a variable rate, or a zero coupon; see Section 8.3.2.4). An entity is not permitted to impute terms in the debt host contract that would result in the identification of an embedded derivative that is not clearly present in the hybrid instrument.

### 8.3.2.3 Hybrid Contracts in the Legal Form of an Outstanding Share

#### 8.3.2.3.1 General

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-16</strong> If 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.</td>
</tr>
<tr>
<td><strong>25-17</strong> Because the changes in fair value of an equity interest and interest rates on a debt instrument are not clearly and closely related, the terms of convertible preferred stock shall be analyzed to determine whether the preferred stock (and thus the potential host contract) is more akin to an equity instrument or a debt instrument.</td>
</tr>
<tr>
<td><strong>25-17A</strong> 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. In 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. For example, 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. Rather, the nature of the host contract depends on the economic characteristics and risks of the entire hybrid financial instrument.</td>
</tr>
</tbody>
</table>
Chapter 8 — Embedded Derivatives

ASC 815-15 (continued)

25-17B The guidance in paragraph 815-15-25-17A relates to determining whether a host contract within a hybrid financial instrument issued in the form of a share is considered to be more akin to a debt instrument or more akin to an equity instrument for the purposes of evaluating one or more embedded derivative features for bifurcation under paragraph 815-15-25-1(a). It is not intended to address when an embedded derivative feature should be bifurcated from the host contract or the accounting when such bifurcation is required. In addition, the guidance in paragraph 815-15-25-17A is not intended to prescribe the method to be used in determining the nature of the host contract in a hybrid financial instrument that is not issued in the form of a share.

If the host contract is in the legal form of a share (e.g., preferred stock), the evaluation of whether the contract should be considered a debt host or an equity host is not based solely on its legal form or whether it qualifies for presentation as equity (including temporary equity) under GAAP. Instead an entity is required to use a “whole-instrument approach” under which it determines the nature of the host contract by considering all of its stated or implied substantive terms and features. Accordingly, an entity must further analyze the economic characteristics and risks of the hybrid contract to determine whether the contract should be considered a debt host or an equity host. For example, an outstanding share that is classified as liability under ASC 480 or as temporary equity under ASC 480-10-599-3A could potentially qualify as a debt host contract depending on its terms and conditions. An entity is not permitted to use (1) a “chameleon approach” under which the nature of the host contract is determined on the basis of an analysis that excludes the embedded feature that is evaluated for bifurcation or (2) a “pure host” approach under which the nature of the host contract is determined by excluding all potential embedded derivative features.

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 is required to reassess that determination upon a modification or exchange of the hybrid instrument that is accounted for as an extinguishment (see Section 10.4.2). The determination of whether a reassessment is required for a modification or exchange that is not accounted for as an extinguishment depends on the relevant facts and circumstances.

Because this Roadmap addresses the issuer’s accounting for debt, the accounting for outstanding shares is beyond its scope except for certain types of liability-classified shares (see Section 2.3.2.3). Liability-classified outstanding shares will generally contain debt host contracts. However, it is possible for a such a share to contain an equity host contract. Furthermore, some equity-classified hybrid instruments will contain debt hosts (in which case the evaluation of embedded derivatives is the same as that for a hybrid instrument that is in the legal form of debt). The sections below therefore discuss the guidance on determining the nature of the host contract for a hybrid instrument in the form of a share.
8.3.2.3.2 Framework for Determining Whether an Outstanding Share Is a Debt Host or an Equity Host

| ASC 815-15 |
|---|---|
| **25-17C** When applying the guidance in paragraph 815-15-25-17A, 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, determining whether those terms and features are debt-like versus equity-like, and weighing those terms and features on the basis of the relevant facts and circumstances. That is, an entity shall consider not only whether the relevant terms and features are debt-like versus equity-like, but also the substance of those terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances). In assessing the substance of the relevant terms and features, each of the following may form part of the overall analysis and may inform an entity's overall consideration of the relative importance (and, therefore, weight) of each term and feature among other terms and features:

  a. The characteristics of the relevant terms and features themselves (for example, contingent versus noncontingent, in-the-money versus out-of-the-money)
  b. The circumstances under which the hybrid financial instrument was issued or acquired (for example, issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized)
  c. The potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes. The assessment of the potential outcomes may be qualitative in nature.

**25-17D** The following are examples (and not an exhaustive list) of common terms and features included within a hybrid financial instrument issued in the form of a share and the types of information and indicators that an entity (an issuer or an investor) may consider when assessing the substance of those terms and features in the context of determining the nature of the host contract, as discussed in paragraph 815-15-25-17C:

  a. Redemption rights. The ability for an issuer or investor to redeem a hybrid financial instrument issued in the form of a share at a fixed or determinable price generally is viewed as a debt-like characteristic. However, not all redemption rights are of equal importance. For example, a noncontingent redemption option may be given more weight in the analysis than a contingent redemption option. The relative importance (and, therefore, weight) of redemption rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

    1. Whether the redemption right is held by the issuer or investors
    2. Whether the redemption is mandatory
    3. Whether the redemption right is noncontingent or contingent
    4. Whether (and the degree to which) the redemption right is in-the-money or out-of-the-money
    5. Whether there are any laws that would restrict the issuer or investors from exercising the redemption right (for example, if redemption would make the issuer insolvent)
    6. Issuer-specific considerations (for example, whether the hybrid financial instrument is effectively the residual interest in the issuer [due to the issuer being thinly capitalized or the common equity of the issuer having already incurred losses] or whether the instrument was issued by a well-capitalized, profitable entity)
    7. If the hybrid financial instrument also contains a conversion right, the extent to which the redemption price (formula) is more or less favorable than the conversion price (formula), that is, a consideration of the economics of the redemption price (formula) and the conversion price (formula), not simply the form of the settlement upon redemption or conversion.
b. Conversion rights. The ability for an investor to convert, for example, a preferred share into a fixed number of common shares generally is viewed as an equity-like characteristic. However, not all conversion rights are of equal importance. For example, a conversion option that is noncontingent or deeply in-the-money may be given more weight in the analysis than a conversion option that is contingent on a remote event or deeply out-of-the-money. The relative importance (and, therefore, weight) of conversion rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether the conversion right is held by the issuer or investors
2. Whether the conversion is mandatory
3. Whether the conversion right is noncontingent or contingent
4. Whether (and the degree to which) the conversion right is in-the-money or out-of-the-money
5. If the hybrid financial instrument also contains a redemption right held by the investors, whether conversion is more likely to occur before redemption (for example, because of an expected initial public offering or change-in-control event before the redemption right becoming exercisable).

c. Voting rights. The ability for a class of stock to exercise voting rights generally is viewed as an equity-like characteristic. However, not all voting rights are of equal importance. For example, voting rights that allow a class of stock to vote on all significant matters may be given more weight in the analysis than voting rights that are only protective in nature. The relative importance (and, therefore, weight) of voting rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. On which matters the voting rights allow the investor's class of stock to vote (relative to common stock shareholders)
2. How much influence the investor's class of stock can exercise as a result of the voting rights.

d. Dividend rights. The nature of dividends can be viewed as a debt-like or equity-like characteristic. For example, mandatory fixed dividends generally are viewed as a debt-like characteristic, while discretionary dividends based on earnings generally are viewed as an equity-like characteristic. The relative importance (and, therefore, weight) of dividend terms among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether the dividends are mandatory or discretionary
2. The basis on which dividends are determined and whether the dividends are stated or participating
3. Whether the dividends are cumulative or noncumulative.

e. Protective covenants. Protective covenants generally are viewed as a debt-like characteristic. However, not all protective covenants are of equal importance. Covenants that provide substantive protective rights may be given more weight than covenants that provide only limited protective rights. The relative importance (and, therefore, weight) of protective covenants among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether there are any collateral requirements akin to collateralized debt
2. If the hybrid financial instrument contains a redemption option held by the investor, whether the issuer's performance upon redemption is guaranteed by the parent of the issuer
3. Whether the instrument provides the investor with certain rights akin to creditor rights (for example, the right to force bankruptcy or a preference in liquidation).
To determine the nature of the host contract under the whole-instrument approach, an entity performs the following steps:

1. Identify all of the hybrid financial instrument’s stated and implied substantive terms and features (see Section 8.3.2.3.3).
2. Determine whether each of the identified terms and features is more debt-like or equity-like (see Section 8.3.2.3.4).
3. Consider the relative weight of the identified terms and features “on the basis of the relevant facts and circumstances” (see Section 8.3.2.3.5).
4. Reach a conclusion about the nature of the host contract (see Section 8.3.2.3.6).

8.3.2.3.3 Step 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. ASC 815-15-25-17D lists common terms and features in hybrid instruments that are in the form of shares.

8.3.2.3.4 Step 2 — Determine Whether the Identified Terms and Features Are More Debt-Like 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, an entity should analyze the terms’ or features’ economic characteristics and risks.

ASC 815-15-25-16 explains that a host contract is 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 factors that an entity might consider in determining the relative weight to assign to such terms and features.
The following chart illustrates which characteristics are generally more equity-like or debt-like:

**Debt-Like Characteristics**
- Redemption rights at a fixed or determinable price* (ASC 815-15-25-17D(a))
- Existence of protective covenants (ASC 815-15-25-17D(e))
- Right to receive mandatory fixed dividends (ASC 815-15-25-17D(d))

**Equity-Like Characteristics**
- Ability to exercise voting rights (ASC 815-15-25-17D(c))
- Ability to convert or otherwise settle into a fixed number of common shares (ASC 815-15-25-17D(b))
- Right to receive discretionary dividends based on earnings (ASC 815-15-25-17D(d))

* Instrument may be settled by the issuer’s transfer of a specified amount of cash or a variable number of shares equal to a fixed dollar amount.

### 8.3.2.3.5 Step 3 — Weigh the Identified Terms and Features

The third step 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 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 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. |
### General View

**Indicators That the General View Should Be Given More Weight**
- 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.

**Indicators That the General View Should Be Given Less Weight**
- 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

**Indicators That the General View Should Be Given More Weight**
- 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.

**Indicators That the General View Should Be Given Less Weight**
- 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

**Dividend Rights**
- 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.

### 8.3.2.3.6 Step 4 — Reach a Conclusion About the Nature of the Host Contract

The final step is to reach a conclusion regarding the nature of the host contract on the basis of the results of the analyses performed in the previous steps. 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, 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 the nature of the host contract is still not clear, the entity should consider the expected outcome of the hybrid financial instrument in reaching a 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.
8.3.2.4 Host Contract Terms

ASC 815-15

25-24 The characteristics of a debt host contract generally shall be based on the stated or implied substantive terms of the hybrid instrument. Those terms may include a fixed-rate, variable-rate, zero-coupon, discount or premium, or some combination thereof.

25-25 In the absence of stated or implied terms, an entity may make its own determination of whether to account for the debt host as a fixed-rate, variable-rate, or zero-coupon bond. That determination requires the application of judgment, which is appropriate because the circumstances surrounding each hybrid instrument containing an embedded derivative may be different. That is, in the absence of stated or implied terms, it is appropriate to consider the features of the hybrid instrument, the issuer, and the market in which the instrument is issued, as well as other factors, to determine the characteristics of the debt host contract. However, an entity shall not express the characteristics of the debt host contract in a manner that would result in identifying an embedded derivative that is not already clearly present in a hybrid instrument. For example, it would be inappropriate to do either of the following:

a. Identify a variable-rate debt host contract and an interest rate swap component that has a comparable variable-rate leg in an embedded compound derivative, in lieu of identifying a fixed-rate debt host contract

b. Identify a fixed-rate debt host contract and a fixed-to-variable interest rate swap component in an embedded compound derivative in lieu of identifying a variable-rate debt host contract.

A contract in the legal form of debt is always considered a debt host contract (see Section 8.3.2.2). If the contract is in the legal form of an outstanding share, the entity must determine whether it has the characteristics and risks of a debt host contract or an equity host contract (see Section 8.3.2.3).

The terms of a debt host contract are identified on the basis of the terms of the hybrid debt instrument. For example, a fixed-rate hybrid debt contract would have a fixed-rate debt host contract, and a variable-rate hybrid debt contract would have a variable-rate debt host contract. An entity is not permitted to impute terms in the host contract that are not clearly present in the hybrid instrument, such as artificial terms that “introduce leverage, asymmetry, or some other risk exposure not already present in the hybrid instrument.” For example, a debtor cannot impute a pay-fixed, receive-variable interest rate swap and identify the debt host contract as variable-rate debt if the hybrid debt instrument makes fixed interest payments.

8.3.2.5 Determining Whether an Embedded Feature Is Clearly and Closely Related to Its Host Contract

ASC 815 contains extensive application guidance on the evaluation of whether particular types of embedded features should be considered clearly and closely related to their host contracts (see Section 8.4). An embedded feature needs to possess principally debt-like characteristics to be considered clearly and closely related to a debt host contract. Contractual terms could potentially qualify as a debt-like feature if they are based on market interest rates, the issuer’s credit risk, or inflation. However, an entity cannot assume that a feature that is based on one of those underlyings is clearly and closely related to a debt host contract without further analysis under the detailed provisions in ASC 815-15 (e.g., the negative-yield test and the double-double test for underlyings based on interest rates; see Section 8.4.1).

The table below provides examples of embedded features that would or would not be considered clearly and closely related to a debt host contract. Note, however, that the assessment could differ depending on the facts and circumstances and other specific requirements of ASC 815.
Because the scope of this Roadmap is limited to debt instruments, it does not address the evaluation of embedded features in equity host contracts.

### 8.3.3 Condition 2 — Hybrid-Instrument Accounting

#### ASC 815-15

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: . . .

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. . . .
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 or ASC 825-10 to a hybrid debt instrument (see Sections 4.4 and 8.5.6), an embedded feature would not be bifurcated. This bifurcation condition would not be met for a financial liability for which the fair value has been elected even though changes in fair value attributable to instrument-specific credit risk are recognized in OCI under ASC 825-10-45-5 (see Section 6.3.2).

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., certain instruments with CCFs or noncontingent BCFs; see Section 7.6), the issuer cannot elect the fair value option for such instruments. Effectively, 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 is available for that instrument.

If a liability is measured at (1) intrinsic value under the indexed-debt guidance in ASC 470-10 (see Section 7.4.5) or (2) settlement value in accordance with ASC 480-10-35-3 (see Sections 4.3.1.2 and 5.3.1.1 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity), an entity should not consider the liability to be accounted for at fair value when assessing whether an embedded feature must be bifurcated. Although the intrinsic value or settlement value might approximate fair value, it does not take into account all of an instrument’s attributes that are included in a fair value estimate — for example, the time value of an option. Thus, an instrument that is remeasured at intrinsic value or settlement value may contain an embedded feature that must be bifurcated.

### 8.3.4 Condition 3 — Derivative Instrument

#### 8.3.4.1 Background

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-1</strong> 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: . . .</td>
</tr>
<tr>
<td>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.)</td>
</tr>
</tbody>
</table>
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.

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. This condition is satisfied if the feature both (1) would have met the definition of a derivative instrument in ASC 815-10 if it had been a freestanding contract and (2) does not meet any of the scope exceptions in ASC 815-10 and ASC 815-15. An entity is not permitted to bifurcate as a derivative an embedded feature that (1) does not meet the definition of a derivative instrument on a freestanding basis or (2) qualifies for a derivative scope exception.

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

- Underlying and either a notional amount or payment provision (see Section 8.3.4.2).
- Initial net investment (see Section 8.3.4.3).
- Net settlement (see Section 8.3.4.4).

Under ASC 815, a feature that does not possess all of these characteristics is not considered a derivative (i.e., it should not be separated as a derivative). Further, a feature that meets the definition of a derivative instrument should not be bifurcated if it meets one or more scope exception in either ASC 815-10-15 or ASC 815-15-15 (see Section 8.3.5).

**8.3.4.2 Underlying, Notional Amount, and Payment Provision Terms**

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.
The first characteristic of a derivative in ASC 815-10-15-83 is that it has both “one or more underlyings” (see Section 8.3.4.2.1 below) and either “one or more notional amounts or payment provisions or both” (see Section 8.3.4.2.2).

8.3.4.2.1 Underlying

<table>
<thead>
<tr>
<th>ASC 815-10 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Underlying</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-88</strong></td>
</tr>
<tr>
<td>An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument. An underlying usually is one or a combination of the following:</td>
</tr>
<tr>
<td>a. A security price or security price index</td>
</tr>
<tr>
<td>b. A commodity price or commodity price index</td>
</tr>
<tr>
<td>c. An interest rate or interest rate index</td>
</tr>
<tr>
<td>d. A credit rating or credit index</td>
</tr>
<tr>
<td>e. An exchange rate or exchange rate index</td>
</tr>
<tr>
<td>f. An insurance index or catastrophe loss index</td>
</tr>
<tr>
<td>g. A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index</td>
</tr>
<tr>
<td>h. The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract).</td>
</tr>
</tbody>
</table>

| **15-89** |
| However, an underlying may be any variable whose changes are observable or otherwise objectively verifiable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. |

| **15-90** |
| Reference to either a notional amount or a payment provision is needed in relation to an underlying to compute the contract’s periodic settlements and resulting changes in fair value. |

| **15-91** |
| Example 3 (see paragraph 815-10-55-77) illustrates the determination of an underlying if a commodity contract includes a fixed element and a variable element. |

All derivatives have one or more underlyings. An underlying is a variable (e.g., a price, rate, index, or the occurrence or nonoccurrence of a specified event) that could cause the payments or other settlements required by a contract to change.
Examples of the underlyings of features embedded in a debt host contract include the following:

- **Interest rates or interest rate indexes** — The interest payments on some debt instruments fluctuate on the basis of changes in market interest rates, such as LIBOR or SOFR. Such fluctuations might be subject to a maximum rate (a cap), a minimum rate (a floor), or a range (collar). In addition, the debtor might have a right to elect which variable interest rate index will apply (a choose-your-rate option). Many debt instruments contain put or call options that could change the rate of return realized by the creditor if they are triggered. See Section 8.4.1 for further discussion.

- **Credit ratings or other measures of credit risk** — Some debt instruments have interest payments that vary on the basis of a measure of the debtor’s credit risk, such as an external credit rating. Alternatively, a debt instrument might require additional interest to be paid upon an event of default involving the debtor. See Section 8.4.2 for further discussion.

- **Inflation rates** — Inflation-indexed debt securities pay interest that varies on the basis of changes in an inflation index, such as a CPI. See Section 8.4.3 for further discussion.

- **The occurrence or nonoccurrence of specified events** — Debt instruments often contain features that accelerate repayment or permit prepayment of amounts due or require specified payments to be made upon the occurrence or nonoccurrence of specified events. For example, debt instruments often contain put or call options that are contingent on the occurrence or nonoccurrence of a change of control, an IPO, a qualified debt or equity financing, the debtor’s stock price, or the debt’s traded price. Further, many debt instruments require additional interest to be paid upon the occurrence or nonoccurrence of specified events, such as the inability to freely trade the instrument or the achievement of business milestones. See Sections 8.4.4 (puts, calls, and other redemption features) and 8.4.11 (other contingent payments) for further discussion.

- **Stock prices or stock price indexes** — When debt is convertible into a fixed number of the debtor’s equity shares (e.g., common or preferred stock), the share price is an underlying of the conversion feature. When the monetary value of the payoff fluctuates on the basis of changes in a stock price, the stock price is considered an underlying even if the contractual terms do not explicitly refer to the stock price. For example, the terms of a conversion feature that requires gross physical settlement in a fixed number of shares upon conversion might not refer to the stock price. Nevertheless, the stock price is an underlying because the monetary value of the conversion feature fluctuates on the basis of changes in the price of the shares that would be delivered upon conversion. See Section 8.4.7 for further discussion.

- **Currency exchange rates or currency exchange rate indexes** — A debt instrument might contain terms that permit payments to be made in more than one currency at a fixed or specified exchange rate. Other debt instruments have principal and interest payments that are denominated in different currencies. See Section 8.4.8 for further discussion.

- **Commodity prices or commodity price indexes** — Sometimes, the payments on a debt instrument fluctuate on the basis of changes in the price of a commodity, such as gold, crude oil, or natural gas. See Section 8.4.9 for further discussion.

- **Sales volume, revenue, or other performance metrics** — Some debt instruments require payments that vary on the basis of changes in measures of sales volume, revenue, or earnings. See Section 8.4.10 for further discussion.

In the determination of the contractual cash flows or other exchanges required by a derivative and its value, the underlying is applied to a notional amount (e.g., an interest rate might be applied to the debt’s outstanding amount) or there is a payment provision (e.g., a fixed payment might be triggered if a specified event occurs).
8.3.4.2.2 Notional Amount or Payment Provision

**ASC 815-10 — Glossary**

**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.

**Payment Provision**
A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

**ASC 815-10**

15-92 A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. Other names are used, for example, the notional amount is called a face amount in some contracts. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. As defined in the glossary, the effective notional amount is the stated notional amount adjusted for any leverage factor. If a requirements contract contains explicit provisions that support the calculation of a determinable amount reflecting the buyer’s needs, then that contract has a notional amount. See paragraphs 815-10-55-5 through 55-7 for related implementation guidance. For implementation guidance on identifying a commodity contract's notional amount, see paragraph 815-10-55-5.

15-93 As defined in the glossary, a payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner. For example, a derivative instrument might require a specified payment if a referenced interest rate increases by 300 basis points.

To meet the definition of a derivative, a contract must contain a notional amount or a payment provision. A notional amount is a quantity that interacts with an underlying in the determination of the cash flows or fair value of the contract. Examples of notional amounts include monetary quantities (e.g., the principal amount of debt) or a number of equity shares (e.g., the number of equity shares that would be received upon conversion of a convertible debt instrument).

A payment provision is a fixed or determinable payment that is triggered by specified changes in the underlying. Examples include the payment of a fixed amount upon the occurrence or nonoccurrence of an event (e.g., change of control or an event of default).

8.3.4.3 Initial Net Investment

**ASC 815-10**

15-83 A derivative instrument is a financial instrument or other contract with all of the following characteristics: . . .

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. . .
The second characteristic of a derivative in ASC 815-10-15-83 is that it has “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.” To evaluate this characteristic, an entity compares the contract's initial net investment with the amount needed to acquire (or incur) the effective notional amount of the asset (or liability) related to the contract's underlying. The characteristic is present if the initial net investment is smaller, by more than a nominal amount, than that for other types of contracts with a similar response to changes in market factors. For example, there is often no initial investment required for freestanding swaps and forward contracts. For freestanding option contracts, the initial investment usually must be smaller than the amount needed to invest in the option's reference asset. If the contract's initial investment approximates the initial investment needed to acquire (or incur) the related asset (or liability), the net investment characteristic is not met.

The initial investment in a hybrid instrument is not considered the initial net investment for an embedded feature in that instrument (as noted in ASC 815-15-25-1). 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, excluding the host contract of the hybrid instrument. That is, the initial investment needed to acquire or incur the host contract (e.g., the fair value of a debt host contract) does not form part of the initial investment of any embedded feature in the same hybrid instrument. Therefore, the initial net investment characteristic typically is met for embedded features in debt host contracts.

**Example 8-3**

**Initial Net Investment in Conversion Option Embedded in a Debt Instrument**

The initial net investment in a conversion option embedded in a debt instrument is the option's fair value; it is not the fair value of the convertible debt or the fair value of the shares that would be delivered upon exercise of the conversion feature. When evaluating whether the initial net investment characteristic is met, an entity compares the fair value of the conversion option on the date of the debt's issuance with the fair value of the underlying shares that are deliverable to the holders upon exercise of the conversion option. If the fair value of the conversion option is less, by more than a nominal amount, than the fair value of the instrument into which the option is convertible on the date of issuance, the initial net investment characteristic is met.
8.3.4.4 **Net Settlement**

8.3.4.4.1 Background

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-83</strong> A derivative instrument is a financial instrument or other contract with all of the following characteristics: . . .</td>
</tr>
<tr>
<td>c. Net settlement. The contract can be settled net by any of the following means:</td>
</tr>
<tr>
<td>1. Its terms implicitly or explicitly require or permit net settlement.</td>
</tr>
<tr>
<td>2. It can readily be settled net by a means outside the contract.</td>
</tr>
<tr>
<td>3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.</td>
</tr>
</tbody>
</table>

| **15-99** A contract fits the description in paragraph 815-10-15-83(c) if its settlement provisions meet criteria for any of the following: |
| a. Net settlement under contract terms |
| b. Net settlement through a market mechanism |
| c. Net settlement by delivery of derivative instrument or asset readily convertible to cash. |

The third characteristic of a derivative in ASC 815-10-15-83 is net settlement. ASC 815-10 specifies that a contract meets the net settlement characteristic in the definition of a derivative if it permits net settlement in any of the following ways: (1) under the contractual terms (see Section 8.3.4.4.2), (2) through a market mechanism (see Section 8.3.4.4.3), or (3) by delivery of a derivative instrument or an asset that is readily convertible to cash (see Section 8.3.4.4).

The table below lists examples of features that may or may not meet the net settlement characteristic if they are embedded in a debt host contract.

<table>
<thead>
<tr>
<th>Net Settlement Characteristic Met</th>
<th>Net Settlement Characteristic Not Met</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Cash-settled put or call option (see Section 8.3.4.4.2).</td>
<td></td>
</tr>
<tr>
<td>• Cash-settled redemption feature (see Section 8.3.4.4.2).</td>
<td></td>
</tr>
<tr>
<td>• Conversion feature that involves delivery of shares that are readily convertible to cash (e.g., publicly traded stock; see Section 8.3.4.4.4).</td>
<td></td>
</tr>
<tr>
<td>• Net-share-settled conversion feature (irrespective of whether the stock is readily convertible to cash; see Section 8.3.4.4.2).</td>
<td></td>
</tr>
<tr>
<td>• Share-settled redemption feature (e.g., a conversion feature that involves the delivery of a variable number of shares worth a specified monetary amount at settlement irrespective of whether the stock is readily convertible to cash; see Section 8.3.4.4.2).</td>
<td></td>
</tr>
<tr>
<td>• Indexed principal or interest payments (see Section 8.3.4.4.2).</td>
<td></td>
</tr>
<tr>
<td>• Contingent payment feature (e.g., additional cash interest upon an event of default; see Section 8.3.4.4.2).</td>
<td></td>
</tr>
<tr>
<td>• Conversion feature that requires gross physical settlement by delivery of a fixed number of shares that are not readily convertible to cash (e.g., private-company stock; see Section 8.3.4.4.4).</td>
<td></td>
</tr>
</tbody>
</table>
8.3.4.4.2 Net Settlement Under Contract Terms

ASC 815-10

Net Settlement Under Contract Terms

15-100 In this form of net settlement, neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). (For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.) Net settlement may be made in cash or by delivery of any other asset (such as the right to receive future payments — see the discussion beginning in paragraph 815-10-15-104), whether or not that asset is readily convertible to cash.

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”) that is equivalent to the gain or loss on the contract. An embedded feature in a debt host contract that is contractually settled net would meet this condition (e.g., a conversion feature that permits net share or net cash settlement of the conversion spread while the principal amount of the debt is settled in cash). If the contractual terms require or permit either party to elect net settlement, the net settlement characteristic is met even if the item that may be delivered upon settlement is not readily convertible to cash (e.g., a net share settlement involving private company shares; see Section 8.4.7).

In accordance with ASC 815-10-15-107, the exercise of an embedded put or call option in a debt host contract is considered a contractual net settlement of that embedded option “because neither party is required to deliver an asset that is associated with the underlying” (see Section 8.4.4.4).

8.3.4.4.3 Net Settlement Through a Market Mechanism

ASC 815-10

Net Settlement Through a Market Mechanism . . .

15-110 In this form of net settlement, one of the parties is required to deliver an asset of the type described in paragraph 815-10-15-100, but there is an established market mechanism that facilitates net settlement outside the contract. (For example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.) Market mechanisms may have different forms. Many derivative instruments are actively traded and can be closed or settled before the contract’s expiration or maturity by net settlement in active markets.

The net settlement characteristic is met if 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 applicable to embedded features since they cannot be settled separately from their host contracts. If a feature is legally detachable and separately exercisable from a contract, it is considered a separate freestanding financial instrument, not an embedded feature (see Section 3.3.2).
8.3.4.4.4 Net Settlement by Delivery of a Derivative Instrument or an Asset Readily Convertible to Cash

**ASC 815-10 — Glossary**

**Readily Convertible to Cash**

Assets that are readily convertible to cash have both of the following:

a. Interchangeable (fungible) units
b. Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

*(Based on paragraph 83(a) of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.)

**ASC 815-10**

**Net Settlement by Delivery of Derivative Instrument or Asset Readily Convertible to Cash**

15-119 In this form of net settlement, one of the parties is required to deliver an asset of the type described in paragraph 815-10-15-100, but that asset is readily convertible to cash or is itself a derivative instrument.

15-121 Examples of assets that are readily convertible to cash include a security or commodity traded in an active market and a unit of foreign currency that is readily convertible into the functional currency of the reporting entity.

15-122 An asset (whether financial or nonfinancial) shall be considered to be readily convertible to cash only if the net amount of cash that would be received from a sale of the asset in an active market is either equal to or not significantly less than the amount an entity would typically have received under a net settlement provision. The net amount that would be received upon sale need not be equal to the amount typically received under a net settlement provision. Parties generally should be indifferent as to whether they exchange cash or the assets associated with the underlying, although the term indifferent is not intended to imply an approximate equivalence between net settlement and proceeds from sale in an active market.

15-123 The form of a financial instrument is important; individual instruments cannot be combined for evaluation purposes to circumvent compliance with the criteria beginning in paragraph 815-10-15-119. Example 8 (see paragraph 815-10-55-111) illustrates this guidance.

**Effect of Conversion Costs**

15-125 If an entity determines that the estimated costs that would be incurred to immediately convert the asset to cash are not significant, then receipt of that asset puts the entity in a position not substantially different from net settlement. Therefore, an entity shall evaluate, in part, the significance of the estimated costs of converting the asset to cash in determining whether those assets are readily convertible to cash.

15-126 For purposes of assessing significance of such costs, an entity shall consider those estimated conversion costs to be significant only if they are 10 percent or more of the gross sales proceeds (based on the spot price at the inception of the contract) that would be received from the sale of those assets in the closest or most economical active market.
The net settlement characteristic is met if the contract is settled in a manner in which the recipient's position is not substantially different from that in a contractual net settlement. Thus, if a contract is settled as a result of a two-way (gross) exchange of items that are readily convertible to cash or are derivatives, the net settlement characteristic is met. ASC 815-10-20 specifies that an item is “readily convertible to cash” if it 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 equity conversion feature embedded in a debt host would be considered readily convertible to cash if the shares that would be delivered upon conversion can be rapidly absorbed in the market without significantly affecting the stock price (see Section 8.4.7.5). If the conversion costs (e.g., sales commissions on the quoted price) would exceed 10 percent of the spot price at the inception of the contract, however, the feature would not be considered readily convertible to cash (see ASC 815-10-15-126). The evaluation of whether an embedded feature is readily convertible to cash is performed on the basis of the smallest increment in which it can be settled under its contractual terms (see Section 8.4.7.5).

**8.3.4.4.5 Ongoing Evaluation**

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-127</strong> The assessment of the significance of . . . conversion costs shall be performed only at inception of the contract.</td>
</tr>
<tr>
<td><strong>15-139</strong> The evaluation of whether items to be delivered under a contract are readily convertible to cash shall be performed at inception and on an ongoing basis throughout a contract’s life (except that, as stated in paragraph 815-10-15-127, the assessment of the significance of those conversion costs shall be performed only at inception of the contract). Example 4, Cases B, C, and D (see paragraphs 815-10-55-87 through 55-89) illustrate this guidance.</td>
</tr>
</tbody>
</table>

**Example 4: Net Settlement at Inception and Throughout a Contract’s Life**

**55-84** As required by paragraphs 815-10-15-110 through 15-118 and 815-10-15-119 through 15-120, respectively, the evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be performed at inception and on an ongoing basis throughout a contract’s life. For example, if a market develops, if an entity effects an initial public offering, or if daily trading volume changes for a sustained period of time, then those events need to be considered in reevaluating whether the contract meets the definition of a derivative instrument. Similarly, if events occur after the inception or acquisition of a contract that would cause a contract that previously met the definition of a derivative instrument to cease meeting the criteria (for example, an entity becomes delisted from a national stock exchange), then that contract cannot continue to be accounted for under this Subtopic. The guidance in paragraphs 815-10-15-125 through 15-127 about assessing the significance of transaction costs is not relevant when determining whether such a contract no longer meets the definition of a derivative instrument.

An entity is required to evaluate whether a market mechanism exists (see Section 8.3.4.4.3) and whether the items to be delivered are readily convertible to cash (see Section 8.3.4.4.4) both at inception and on an ongoing basis throughout a contract’s life. For example, an embedded conversion feature might become readily convertible to cash after the issuance of a debt contract if the shares to be delivered upon exercise of the conversion feature are not initially readily convertible to cash but the entity subsequently undertakes an IPO or the market trading volume increases such that those shares become capable of being rapidly absorbed in the market without significantly affecting the stock price (see Section 8.4.7.5.6). Conversely, an embedded conversion feature might cease to be readily convertible to cash if the shares are no longer listed on a stock exchange. However, an entity should not reassess whether the costs needed to immediately convert the asset to cash would exceed 10 percent of the spot price.
8.3.5 **Scope Exceptions**

**ASC 815-10**

15-13 Notwithstanding the conditions in paragraphs 815-10-15-83 through 15-139, the following contracts are not subject to the requirements of this Subtopic if specified criteria are met:

a. Regular-way security trades  
b. Normal purchases and normal sales  
c. Certain insurance contracts and market risk benefits [Underscored text added by ASU 2018-12]  
d. Certain financial guarantee contracts  
e. Certain contracts that are not traded on an exchange  
f. Derivative instruments that impede sales accounting  
g. Investments in life insurance  
h. Certain investment contracts  
i. Certain loan commitments  
j. Certain interest-only strips and principal-only strips  
k. Certain contracts involving an entity’s own equity  
l. Leases  
m. Residual value guarantees  
n. Registration payment arrangements  
o. Certain fixed-odds wagering contracts [Added by ASU 2016-20].

**ASC 815-15**

15-3 The guidance in this Subtopic does not apply to any of the following items, as discussed further in this Section:

a. Normal purchases and normal sales contracts  
b. Unsettled foreign currency transactions  
c. Plain-vanilla servicing rights  
d. Features involving certain aspects of credit risk  
e. Features involving certain currencies.

An embedded derivative that meets a derivative accounting scope exception in ASC 815-10-15-13 or ASC 815-15-15-3 should not be bifurcated from its host contract. Some of those scope exceptions might be more relevant to a debtor that evaluates features embedded in debt host contracts, including those related to the following:

- Certain insurance contracts (see ASC 815-10-15-52 through 15-57). A contract or feature is not subject to ASC 815 “if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.” A disaster bond might qualify for this scope exception (see Section 8.4.12.4).

- Certain financial guarantee contracts (see ASC 815-10-15-58). An embedded credit derivative in a credit-linked note could potentially qualify for this scope exception (see Section 8.4.2.5).
• Certain contracts that are not traded on an exchange if the underlying on which the settlement is based on one of the following (ASC 815-10-15-59):
  ○ A climatic or geological or other physical variable.
  ○ The price or value of a nonfinancial asset of one of the parties to the contract if the asset is not readily convertible to cash. For example, this scope exception may be relevant for a participation feature in a participating mortgage (see Sections 7.3 and 8.4.9.5).
  ○ The fair value of a nonfinancial liability of one of the parties to the contract and the asset delivered is not readily convertible to cash.
  ○ Specified volumes of sales or service revenue 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 (see Sections 7.2 and 8.4.10.5).

• Loan commitments (see ASC 815-10-15-69 through 15-71 and Section 8.4.6.5). Note that an entity may evaluate a term extension option (see Section 8.4.5.5) or PIK feature embedded in a debt instrument to determine whether it meets this scope exception.

• Contracts that are both indexed to the entity’s own stock and classified in stockholders’ equity (see ASC 815-10-15-74(a)). An entity would evaluate an embedded conversion feature to determine whether it meets this scope exception (see Section 8.4.7.6).

• Contracts within the scope of ASC 718 (see ASC 815-10-15-74(b)). A convertible debt instrument issued in exchange for goods or services may meet this scope exception (see Section 8.4.7.7).

• Registration payment arrangements (ASC 815-10-15-82; see Sections 3.3.3.2 and 8.4.12.2).

• Monetary items that have principal or interest payments denominated in a foreign currency and for which foreign currency transaction gains and losses are recognized under ASC 830 (see Section 8.4.8.5). For example, this exception applies to certain dual currency bonds.

8.4 Application to Specific Embedded Features

8.4.1 Features Related to an Interest Rate

8.4.1.1 Background

This section discusses the analysis of whether an embedded feature that could adjust the payments on a debt host contract that is based solely on an interest rate or interest rate index should be separated as a derivative. Examples of contractual provisions in debt contracts that should be evaluated under the guidance discussed in this section include:

• Interest payments that that are leveraged on the basis of market interest rates (e.g., the contractual interest rate is a multiple of a benchmark interest rate).

• Interest payments that move inversely with market interest rates (e.g., when market interest rates increase, the contractual interest rate decreases).

• Interest payments that are based on a tenor of a benchmark interest rate that is different from the tenor of the interest payments (e.g., a constant maturity yield).

• Choose-your-rate options (e.g., the debtor can elect to switch the basis of future variable-interest-rate payments to a different benchmark interest rate).

• Caps, floors, or collars on interest payments indexed to a market interest rate.
• Interest rate adjustments that are contingent on the level of interest rates.
• Certain put and call options that are not otherwise required to be viewed as not clearly and closely related to the debt host contract (see Section 8.4.4.3).

This section does not address features that are contingent on, or indexed to, underlyings other than an interest rate or interest rate index, including features that are indexed to both interest rates and other underlyings (see Section 8.4.1.3.2).

8.4.1.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of an embedded feature that is based solely on an interest rate or interest rate index and could adjust the cash flows of a debt host contract. However, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>It depends</td>
<td>The issuer must evaluate whether an interest-related feature is clearly and closely related to a debt host in accordance with the negative-yield test and the double-double test (ASC 815-15-25-26; see Section 8.4.1.3).</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). However, the fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>Yes</td>
<td>An interest-rate-related feature that adjusts the payments of a debt host contract meets the definition of a derivative (see Section 8.4.1.4).</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>No</td>
<td>No scope exception is available for features that are based solely on an interest rate or an interest rate index (see Section 8.3.5).</td>
</tr>
</tbody>
</table>

As shown in the table above, a debtor's determination of whether it must bifurcate as a derivative an embedded feature that is based solely on an interest rate or interest rate index and could adjust the payments of a debt host contract tends to focus on whether the feature is considered clearly and closely related to the debt host contract unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10. Typically, such features meet the definition of a derivative and are not exempt from derivative accounting.
8.4.1.3 **Clearly-and-Closely-Related Analysis**

8.4.1.3.1 General

ASC 815-15

**25-26** 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 either of the following conditions exists:

a. 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).

b. 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.

**25-27** Even though the conditions in (a) and (b) in the preceding paragraph focus on the investor's rate of return and the investor's recovery of its investment, the existence of either of those conditions would result in the embedded derivative not being considered clearly and closely related to the host contract by both parties to the hybrid instrument. Because the existence of those conditions is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions in the preceding paragraph at different points in time.

**25-28** An embedded derivative that alters net interest payments based on changes in a stock price index (or another non-interest-rate index) is not addressed in paragraph 815-15-25-26.

ASC 815-15-25-26 addresses whether an embedded feature whose only underlying is an interest rate or interest rate index should be considered clearly and closely related to a debt host contract.

There are two conditions in ASC 815-15-25-26: one that focuses on the investor's recovery of its investment (the negative-yield test; see Section 8.4.1.3.3) and one that focuses on the investor's rate of return (the double-double test; see Section 8.4.1.3.4). If either of these conditions is met, neither party to the hybrid instrument would consider the embedded derivative feature clearly and closely related to the host contract.

ASC 815-15-25-26 indicates that when an entity assesses whether it meets these conditions, it should not consider the likelihood that a condition will be satisfied — the condition is met if there is any possibility whatsoever that it will be met.
8.4.1.3.2 Features That Are Indexed to Both Interest Rates and Other Underlyings

Because ASC 815-15-25-26 only applies to embedded features “in which the only underlying is an interest rate or interest rate index,” it does not apply to features that are indexed to, or contingent on something other than an interest rate or an interest rate index, including features that are indexed to both an interest rate or interest rate index and other underlyings. An embedded put, call, or other redemption feature whose exercise is contingent on the occurrence or nonoccurrence of a specified uncertain, future event (e.g., an IPO or a change in control) would always have a second underlying (the occurrence or nonoccurrence of the specified event). Therefore, the redemption feature would only be subject to evaluation under ASC 815-15-25-26 if the event is solely related to an interest rate or an interest rate index (e.g., an embedded call option that may only be exercised when LIBOR is at or above 5 percent).

Although an embedded feature that has a payoff that is indexed to both interest rates and another underlying (e.g., an event of default, a stock price, commodity price, or the entity’s stock market capitalization) is not subject to an evaluation under ASC 815-15-25-26, such a feature would not be considered clearly and closely related to a debt host contract unless either (1) the other underlying is based on the issuer’s credit risk (see Section 8.4.2) or inflation (see Section 8.4.3) or (2) the feature is a contingent redemption feature that otherwise does not have to be separated under the guidance on such features (see Section 8.4.4).

For guidance on the evaluation of features that are indexed to underlyings other than an interest rate or interest rate index, see, for example, Sections 8.4.2 (credit-sensitive payments), 8.4.3 (inflation-indexed payments), 8.4.7 (equity-indexed payments), 8.4.8 (foreign currency features), 8.4.9.3 (commodity-indexed payments), 8.4.10 (revenue-indexed payments), and 8.4.11 (other payments contingent on underlyings other than interest rates, credit risk, or inflation).

8.4.1.3.3 Negative-Yield Test

Under the negative-yield test (i.e., ASC 815-15-25-26(a)), an embedded interest rate feature is not clearly and closely related to its debt host contract if it could contractually cause the debt to be settled in such a way that the investor would not recover substantially all of its initial recorded investment. In other words, this test might be passed if it is contractually possible that the creditor could be forced to accept a negative yield on its investment.

The debtor performs the test as of the date on which it initially recognizes the debt and does not subsequently reassess whether the test is passed.

Example 8-4

Bond With Leverage Feature

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 three-month LIBOR, without a floor, for the remaining term of the bond. If three-month LIBOR were to increase significantly, the bond might result in a negative return, which would effectively erode the bond’s principal. In that case, X may not recover substantially all of its initial investment. Company X and the bond issuer should, therefore, separately account for the embedded interest rate derivative unless the entire hybrid financial instrument is recognized at fair value, with changes in fair value recognized in earnings.
In practice, the phrase “substantially all” in ASC 815-15-25-26(a) is interpreted to mean at least 90 percent of the original investment. The test is performed on an undiscounted basis. If, at inception, there is any contractual possibility whatsoever that the undiscounted contractual net cash flows received by the creditor over the life of the instrument will not be at least 90 percent of the investment recorded by the investor at inception, the negative-yield test is passed and the debtor would consider the feature not to be clearly and closely related to the debt host. Otherwise, an embedded feature that is based only on an interest rate or interest rate index would be considered clearly and closely related to its host provided that it does not pass the double-double test (ASC 815-15-25-26(b); see Section 8.4.1.3.4).

ASC 815-15

25-29 The condition in paragraph 815-15-25-26(a) applies only to those situations in which the investor (creditor) could be forced by the terms of a hybrid instrument to accept settlement at an amount that causes the investor not to recover substantially all of its initial recorded investment. That condition does not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, provided that the issuer does not have the contractual right to demand a settlement that causes the investor not to recover substantially all of its initial net investment.

If scenarios exist in which the investor contractually would not recover substantially all of its initially recorded investment, but the creditor could not be forced to accept such a settlement or could prevent such a scenario from occurring, the negative-yield test is not passed. The negative-yield test only applies to scenarios in which the creditor could be forced to accept a settlement under which it would not recover substantially all of its initial recorded investment. If the creditor has a right, but not an obligation to settle the debt at an amount that is less than substantially all of its initially recorded investment (e.g., an embedded put option held by the creditor that has an exercise price at a significant discount to the initial investment), the negative-yield test is not passed.

Further, the negative-yield test does not reflect the risk that that the debtor might breach the contract (i.e., the test is not met merely because of the risk that the debtor may default on its obligation to repay the debt). The negative-yield test only applies to scenarios in which the creditor contractually is at risk of not recovering substantially all of its initial recorded investment.

Example 10: Interest-Rate-Related Underlyings — Recovering Substantially All of an Initial Recorded Investment

Case A: Note A

55-130 If an investor in a 10-year note has the contingent option at the end of Year 2 to put it back to the issuer at its then fair value (based on its original 10-year term), the condition in paragraph 815-15-25-26(a) would not be met even though the note's fair value could have declined so much that, by exercising the option, the investor ends up not recovering substantially all of its initial recorded investment. See paragraph 815-15-25-29.
Case B: Note B

55-131 An investor purchased from an A-rated issuer for $10 million a structured note with a $10 million principal, a 9.5 percent interest coupon, and a term of 10 years at a time when the current market rate for 10-year A-rated debt is 7 percent. Assume that the terms of the note require that, at the beginning of the third year of its term, the principal on the note be reduced to $7.1 million and the coupon interest rate be reduced to zero for the remaining term to maturity if interest rates for A-rated debt have increased to at least 8 percent by that date. That structured note would meet the condition in paragraph 815-15-25-26(a) for both the issuer and the investor because the investor could be forced to accept settlement that causes the investor not to recover substantially all of its initial recorded investment. That is, if increases in the interest rate for A-rated debt trigger the modification of terms, the investor would receive only $9 million, comprising $1.9 million in interest payments for the first 2 years and $7.1 million in principal repayment, thus not recovering substantially all of its $10 million initial net investment.

Case C: Note C

55-132 The investor purchases for $10,000,000 a structured note with a face amount of $10,000,000, a coupon of 8.9 percent, and a term of 10 years. The current market rate for 10-year debt is 7 percent given the A credit quality of the issuer. The terms of the structured note require that if the interest rate for A-rated debt has increased to at least 10 percent at the end of 2 years, the coupon on the note be reduced to zero, and the investor purchase from the issuer for $10,000,000 an additional note with a face amount of $10,000,000, a zero coupon, and a term of 3.5 years.

55-133 The structured note contains an embedded derivative that shall be accounted for separately unless a fair value election is made pursuant to paragraph 815-15-25-4.

55-134 The requirement that, if interest rates increase and the embedded derivative is triggered, the investor purchase the second $10,000,000 note for an amount in excess of its fair value (which is about $7,100,000 based on a 10 percent interest rate) generates a result that is economically equivalent to requiring the investor to make a cash payment to the issuer for the amount of the excess. As a result, the cash flows on the original structured note and the excess purchase price on the second note shall be considered in concert. The cash inflows ($10,000,000 principal and $1,780,000 interest) that will be received by the investor on the original note shall be reduced by the amount ($2,900,000) by which the purchase price of the second note is in excess of its fair value, resulting in a net cash inflow ($8,880,000) that is not substantially all of the investor's initial net investment on the original note.

55-135 As demonstrated by this Case, if an embedded derivative requires an asset to be purchased for an amount that exceeds its fair value, the amount of the excess — and not the cash flows related to the purchased asset — shall be considered when analyzing whether the hybrid instrument can contractually be settled in such a way that the investor would not recover substantially all of its initial recorded investment under paragraph 815-15-25-26(a). Whether that purchased asset is a financial asset or a nonfinancial asset (such as gold) is not relevant to the treatment of the excess purchase price. It is noted that requiring the investor to make a cash payment to the issuer is also economically equivalent to reducing the principal on the note.

55-136 The note described could have been structured to include terms requiring that the principal of the note be substantially reduced and the coupon reduced to zero if the interest rate for A-rated debt increased to at least 10 percent at the end of 2 years. That alternative structure would clearly have required that the embedded derivative be accounted for separately, because that embedded derivative's existence would have resulted in the possibility that the hybrid instrument could contractually be settled in such a way that the investor would not recover substantially all of its initial recorded investment.
8.4.1.3.4 Double-Double Test

Under the double-double test (i.e., ASC 815-15-25-26(b)), an embedded interest rate feature is not clearly and closely related to its debt host contract if there is a potential scenario in which the investor could achieve a rate of return on the host contract that at least doubles its initial rate of return and is twice what would otherwise be the market return.

The debtor evaluates whether the double-double test is passed as of the date on which it initially recognizes the instrument. It does not subsequently reassess whether the test is passed.

This test is performed in two steps.

- **Step 1** — The debtor determines whether there is a possible future interest rate scenario, no matter how remote, in which the embedded feature would at least double the investor’s initial rate of return on the host contract. In making this assessment, an entity must be certain to differentiate between the return on the host contract and the return on the hybrid instrument (see Section 8.2.1). The initial rate of return on the host contract excludes the effects of the embedded feature. If no such scenario exists, the embedded feature would be considered clearly and closely related to its host provided that it does not pass the negative-yield test (ASC 815-15-25-26(a); see Section 8.4.1.3.3). If any such scenario exists, the debtor must proceed to step 2 below.

- **Step 2** — The debtor determines whether, for any of the scenarios identified in the first step 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 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. If such a high return is possible, the embedded feature would not be considered clearly and closely related to its host contract. If such a high return is not possible for a feature that is based solely on an interest rate or interest rate index and the embedded feature also does not pass the negative-yield test (ASC 815-15-25-26(a); see Section 8.4.1.3.3), the embedded feature is considered clearly and closely related to the host contract.

Example 8-5

**Debt With Interest Step-Up Feature**

Company A invests in 30-year variable-rate debt issued by Company B. The debt is indexed to the three-month LIBOR rate plus 4 percent. As of the date of issuance, the three-month LIBOR rate was 2 percent. The debt’s terms also specify that if the three-month LIBOR rate 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 30-year variable-rate debt without any embedded derivatives (i.e., the interest rate reset feature), it would pay a coupon of three-month LIBOR plus 6 percent. Consequently, the initial rate of return on the host contract is 8 percent (three-month 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 three-month LIBOR increases to 5 percent, the 23 percent interest rate feature more than doubles the initial rate of return of 8 percent on the host contract; therefore, the first condition is satisfied.
Example 8-5 (continued)

To apply the second part of ASC 815-15-25-26(b), A must determine 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 three-month 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 three-month LIBOR increases to 5 percent, the rate of return on a contract with the same terms as the host contract (and involving a debtor with a credit quality similar to B's credit quality at debt inception) would be 11 percent (three-month LIBOR of 5 percent plus 6 percent). The second condition is, therefore, also satisfied, because when three-month 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 (three-month LIBOR of 5 percent plus 6 percent) on the contract with the same terms as the host contract.

Both A and B would be required to account for the embedded derivative separately unless the entire hybrid financial instrument is recognized at fair value, with changes in fair value recognized in earnings. Note that ASC 815-15-25-26 indicates that when an entity assesses whether it meets one of the conditions, it should not consider the probability that the condition will be satisfied; the condition should be considered satisfied if there is any possibility whatsoever that the condition will be met. Therefore, the probability that the three-month LIBOR rate 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 any bifurcated embedded derivative.

ASC 815-15

25-37 The conditions in paragraph 815-15-25-26(b) do not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor (the issuer or the borrower). This guidance does not affect the application of the condition in paragraph 815-15-25-26(a) or the application of paragraphs 815-15-25-41 through 25-43. In addition, this guidance does not apply to other embedded derivative features that may be present in the same hybrid instrument.

25-38 The conditions in paragraph 815-15-25-26(b) apply only to situations that meet the two conditions specified in paragraph 815-15-25-26(b)(1) through (b)(2) and for which the investor has the unilateral ability to obtain the right to receive the high rate of return specified in those paragraphs. If the embedded derivative is an option rather than a forward contract, it is important to analyze whether the investor is the holder of that option. For an embedded call option, the issuer or borrower (and not the investor) is the holder, and thus only the issuer (borrower) can exercise the option. Consequently, the investor does not have the unilateral ability to obtain the right to receive the high rate of return, which is contingent on the issuer's exercise of the embedded call option.

If scenarios exist in which the investor could double its initial return but the debtor could prevent any such scenarios from occurring, the double-double test does not apply. For example, the double-double test does not apply if the debtor has a right, but not an obligation, to settle the debt at an amount that would pass the double-double test (e.g., an embedded call option held by the debtor that has an exercise price that potentially could double the investor's initial return). The double-double test is passed only if scenarios exist in which the debtor contractually could not prevent a settlement that would pass the double-double test. ASC 815-15-55-25 (below) contains six examples that illustrate this concept.
### ASC 815-15

55-25 Application of the guidance in paragraphs 815-15-25-37 through 25-39 to specific debt instruments is provided in the following table.

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Paragraph 815-15-25-26(b) Applicable to the Embedded Call Option?</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. An unsecured commercial loan that includes a prepayment option that permits the loan to be prepaid by the borrower at a fixed amount at any time at a specified premium over the initial principal amount of the loan.</td>
<td>No.</td>
<td>The commercial loan is prepayable only at the option of the borrower.</td>
</tr>
<tr>
<td>2. A fixed-rate debt instrument issued at a discount that is callable at par value at any time during its 10-year term.</td>
<td>No.</td>
<td>The fixed-rate debt instrument is callable at par value only by the issuer.</td>
</tr>
<tr>
<td>3. A fixed-rate 10-year bond that contains a call option that permits the issuer to prepay the bond at any time after issuance by paying the investor an amount equal to all the future contractual cash flows discounted at the then-current Treasury rate plus 45 basis points. The spread over the Treasury rate for the borrower at the issuance of the bond was 300 basis points.</td>
<td>No.</td>
<td>The fixed-rate 10-year bond is callable only at the option of the issuer.</td>
</tr>
<tr>
<td>4. A 5-year debt instrument issued at par that has a quarterly coupon equal to 15 percent minus 3 times 3-month LIBOR and that includes a call provision that allows the issuer to call the debt at any time at a specified premium over par.</td>
<td>No.</td>
<td>The instrument is callable only by the issuer, so the embedded call option feature will not be subject to the conditions in paragraph 815-15-25-26(b). However, the conditions in the paragraph are still applicable to the levered index feature of the debt.</td>
</tr>
<tr>
<td>5. A fixed rate debt instrument is issued at par and is callable at any time during its 10-year term. If the debt is called, the investor receives the greater of the par value of the debt or the market value of 100,000 shares of XYZ common stock (an unrelated entity).</td>
<td>No.</td>
<td>The instrument is callable only by the issuer, so the embedded call option feature will not be subject to the conditions in paragraph 815-15-25-26(b). However, the embedded call option is not considered clearly and closely related to the debt host contract because the payoff is based on an equity price.</td>
</tr>
<tr>
<td>6. A mortgage-backed security is issued, whereby cash flows associated with principal payments (including full or partial prepayments and related penalties) received on the related mortgage loans are passed through to the mortgage-backed security investors.</td>
<td>Not applicable (see comments).</td>
<td>Although the related mortgage loans are prepayable, and thus each contain a separate embedded call option, the mortgage-backed security itself does not contain an embedded call option. While the mortgage-backed security investor is subject to prepayment risk, the mortgage-backed security issuer has the obligation (not the option) to pass through cash flows from the related mortgage loans to the mortgage-backed security investors. Therefore, mortgage-backed securities are not within the scope of this guidance. Paragraphs 815-15-25-33 through 25-36 address the application of paragraph 815-15-25-26(b) to securitized interests in prepayable financial assets.</td>
</tr>
</tbody>
</table>
8.4.1.3.5 Interest Rate Caps, Floors, and Collars

**ASC 815-15**

**25-32** Floors or caps (or collars, which are combinations of caps and floors) on interest rates and the interest rate on a debt instrument are considered to be clearly and closely related unless the conditions in either paragraph 815-15-25-26(a) or 815-15-25-26(b) are met, in which circumstance the floors or the caps are not considered to be clearly and closely related.

Caps, floors, or collars on floating-rate interest payments are considered clearly and closely related to a debt host contract unless the negative-yield test or the double-double test (ASC 815-15-25-26) is passed (see Sections 8.4.1.3.3 and 8.4.1.3.4).

**Example 8-5**

**Debt With Embedded Floor**

Company A issues five-year variable-rate debt to the public that is indexed to the LIBOR rate (LIBOR plus 1 percent). LIBOR is currently 6 percent. The investors required that A pay not less than 5 percent at any time during the term of the debt. The agreement that A will not pay an interest rate less than 5 percent on its variable-rate debt represents a floor. If A were to issue a five-year variable-rate debt without a floor, it would pay LIBOR plus 2 percent. The floor would not pass the negative-yield test (ASC 815-15-25-26(a); see Section 8.4.1.3.3) because it could not result in a failure of the investor to recover substantially all of its initial investment. The floor would not pass the double-double test (ASC-815-25-26(b); see Section 8.4.1.3.4) because it could not result in a rate of return that is more than double the initial rate of return of 8 percent (LIBOR at inception plus 2 percent). The floor, when in-the-money, will only result in a rate of 5 percent.

**Example 8-6**

**Debt With Embedded Cap**

On January 1, 20X1, Company X purchases a bond at par that pays LIBOR. The bond also incorporates an interest rate cap provision under which if LIBOR equals or exceeds 8 percent as of any interest rate reset date, X will receive a return of 10 percent. On the date on which X purchases the bond, it also could purchase at par a variable-rate bond not containing a cap that pays LIBOR minus 1 percent from a debtor that has the same credit quality as the issuer of X's bond. As of January 1, 20X1, LIBOR is 5 percent. The bond cannot contractually be settled such that X would not recover substantially all of its initial recorded investment in the bond (i.e., the negative-yield test in ASC 815-15-25-26(a) is not passed; see Section 8.4.1.3.3). To perform the first step of the double-double test (ASC 815-15-25-26(b); see Section 8.4.1.3.4), X 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</th>
<th>B Return Reflecting the Effect of Cap</th>
<th>C Initial Rate of Return on Host (LIBOR Minus 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>

184
Example 8-6 (continued)

Since the first step suggests that there is a possible scenario in which X could double its initial rate of return on the host contact, X must perform the second step in ASC 815-15-25-26(b) to determine whether the embedded cap is clearly and closely related to the debt host contract. For this test, X must determine, for any of the possible interest rate scenarios identified above under which X’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 that involves a debtor with a credit quality similar to the issuer’s credit quality at inception. Company X’s analysis for this test can be summarized as follows:

<table>
<thead>
<tr>
<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>
<th>Return Reflecting the Effect of the Cap Under the Interest Rate Scenario in A</th>
<th>Current Market Rate for a Contract Having the Same Terms as the Host Contract Under the Interest Rate in A (LIBOR Minus 1%)</th>
<th>Is the ASC 815-15-25-26(b)(2) Test Met — Is B at Least Twice C for Any Scenario?</th>
</tr>
</thead>
<tbody>
<tr>
<td>8% and up</td>
<td>10%</td>
<td>7% and up</td>
<td>No</td>
</tr>
</tbody>
</table>

Since the second step suggests that there is no possible scenario in which the investor would achieve a rate of return that is at least twice what otherwise would be the then-current market return, the embedded cap is considered clearly and closely related to the debt host contract under the double-double test (ASC 815-15-25-26(b); see Section 8.4.1.3.4).

Example 8-7

Debt With LIBOR-Indexed Interest Rate Adjustment

On January 1, 20X0, an entity issues a variable-rate debt instrument at par, maturing on January 1, 20X5. The interest rate is three-month LIBOR plus 0.40 percent as long as three-month LIBOR remains at or above 6.00 percent. In periods in which three-month LIBOR drops below 6.00 percent, the interest rate on the debt is calculated as follows: three-month LIBOR plus 0.40 percent – (2 × [6.00% – 3-month LIBOR]). The following table illustrates the interest rate on the debt under certain conditions:

<table>
<thead>
<tr>
<th>Three-Month LIBOR</th>
<th>Interest Rate on Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.00%</td>
<td>7.40%</td>
</tr>
<tr>
<td>5.00%</td>
<td>3.40%</td>
</tr>
<tr>
<td>3.00%</td>
<td>(2.60%)</td>
</tr>
</tbody>
</table>

For the embedded derivative to be considered clearly and closely related to the debt host, the hybrid instrument cannot contractually be settled in such a way that the investor would not recover substantially all of its initial recorded investment (ASC 815-15-25-26(a); see Section 8.4.1.3.3). In this case, it is possible for the investor in the debt to incur a negative return, thus not recovering substantially all of its original investment. Therefore, the embedded floor would not be considered clearly and closely related to the debt host.
Example 8-7 (continued)

However, if the agreement were to contain a provision that guaranteed a cumulative minimum rate of return to the investor over the life of the debt, thereby eliminating the circumstance in which the debt could contractually be settled in such a way that the investor would not recover substantially all of its initial recorded investment, the embedded derivative could not cause the investor not to recover substantially all of its initial recorded investment. For example, the agreement could contain a minimum interest rate clause such that if the defined interest rate is less than zero, negative interest accrues. However, accrued negative interest may only be applied to (1) future interest payments required under this debt or (2) the principal amount only to the extent of interest previously paid under the debt agreement, provided that any accrued interest remains at maturity of the debt. Therefore, the instrument cannot contractually be settled in such a way that the investor would not recover substantially all of its initial recorded investment. The leveraged interest rate terms and floor would be considered clearly and closely related to the debt (provided that under ASC 815-15-25-26(b)’s double-double test [see Section 8.4.1.3.4] those embedded features are clearly and closely related to the debt host). A cap on a leveraged interest rate index would be similarly analyzed under ASC 815-15-25-26 through 25-29.

8.4.1.3.6 Interest Rate Tenor Mismatch (Including Constant Maturity Rates)

The contractual interest rate of many debt securities is based on a reference index. It is not uncommon for the contractual terms of some securities to require the contractual interest rate to reset more frequently than the term of the index the securities are referenced to. One example is a debt security whose interest rate resets every six months to a 10-year index (i.e., a constant maturity rate). Such an interest rate index should be evaluated under ASC 815-15-25-26.

Example 8-8

Debt With Interest Rate Tenor Mismatch

Assume that a 30-year note has an initial yield of 4 percent and that the contractual interest rate resets semiannually to a 10-year index interest rate plus 100 basis points rather than to the six-month rate. The initial yield on a security that resets to the six-month rate, but that otherwise has terms that are identical to those of the 30-year note, is 3 percent.

Because the interest rate resets semiannually to a point further out than the next reset date on the interest rate curve (i.e., a 10-year rate vs. a six-month rate), there are possible future interest rate scenarios under which the initial rate of return on the host contract and the then-current market rate would be doubled. The application of the double-double test (ASC 815-15-25-26(b); see Section 8.4.1.3.4) is shown in the table below:

<table>
<thead>
<tr>
<th>Step 1: Is there a possible 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?</th>
<th>Yes. It is possible that the 10-year index rate could be more than double the investor's initial rate of return on the host contract, which is 3 percent.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 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, could the embedded derivative 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?</td>
<td>Yes. It is possible that the 10-year index rate could be more than double the six-month rate on the same date; therefore, the embedded derivative could result in a rate of return that is at least twice the then-current market return for a contract that has the same terms as the host contract, which resets to the current six-month rate. Note that it is irrelevant whether it is probable that the 10-year rate will rise to more than twice the six-month rate.</td>
</tr>
</tbody>
</table>
Because both conditions in ASC 815-15-25-26(b) are met, the embedded interest rate index is not considered clearly and closely related to the debt host of the 30-year note. If the instrument contains a cap that is less than double the initial rate of return on the host contract, however, the conditions in ASC 815-15-25-26(b) would not be met.

### 8.4.1.3.7 Choose-Your-Rate Option

Variable-rate credit facilities often include an option for the debtor to change the interest rate index that is used as the basis for calculating interest rate payments on outstanding debt (e.g., an option to switch from one benchmark interest rate to another benchmark interest rate). Such a feature is clearly and closely related to its debt host contract unless the negative-yield test or the double-double test (ASC 815-40-15-26) is passed (see Sections 8.4.1.3.3 and 8.4.1.3.4, respectively).

### 8.4.1.3.8 Examples


### 8.4.1.4 Derivative Analysis

The table below presents an analysis of whether an embedded feature that is based solely on an interest rate or interest rate index and could adjust the payments of a debt host contract meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
<td>An embedded feature that could adjust the payments of a debt host contract solely on the basis of an interest rate or interest rate index typically has both an underlying (i.e., the interest rate or interest rate index) and a notional amount (i.e., the amount on which the interest rate adjustment is based, such as the debt's outstanding amount) or payment provision (e.g., a fixed cash payment contingent on an interest rate or interest rate index).</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
<td>The initial net investment in an embedded feature is its fair value (i.e., the amount that would need to be paid to acquire the interest-rate-related feature on a stand-alone basis without the host contract). Generally, an embedded feature that could adjust the cash flows of a debt host contract solely on the basis of an interest rate or interest rate index has an initial net investment that is smaller than would be required for a direct investment that has the same exposure to changes in interest rates (since the investment in the debt host contract does not form part of the initial net investment for the embedded feature).</td>
</tr>
<tr>
<td>Net settlement (see Section 8.3.4.4)</td>
<td>Yes</td>
<td>An embedded feature that adjusts the payments of a debt host contract solely on the basis of an interest rate or interest rate index meets the net settlement condition (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 feature's notional amount).</td>
</tr>
</tbody>
</table>
As shown in the table above, an embedded feature that is based solely on an interest rate or interest rate index and could adjust the payments of a debt host contract typically meets the definition of a derivative. Therefore, the analysis of whether it must be bifurcated as a derivative tends to focus on whether the feature is considered clearly and closely related to the debt host contract (see Section 8.4.1.3) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3).

### 8.4.2 Credit-Risk-Related Features

#### 8.4.2.1 Background

Examples of contractual provisions in debt contracts that could adjust payments on the basis of a measure of credit risk include:

- A provision that requires the debtor to pay additional interest (e.g., 2 percent per annum) upon the debtor’s event of default.
- A feature that adjusts interest payments on the basis of a measure of the debtor’s creditworthiness (e.g., a table that specifies different margins over a benchmark interest rate on the basis of a measure of the debtor’s working capital).
- A feature that adjusts principal or interest payments on the basis of the credit risk of a third party.

This section does not address features that could accelerate the repayment of the outstanding amount of the debt in cash upon the occurrence or nonoccurrence of a specified event such as an event of default. Such features should be evaluated as contingent redemption features (see Section 8.4.4).

#### 8.4.2.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of a credit-risk-related feature embedded in a debt host contract. However, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>It depends</td>
<td>A credit-sensitive payment that is based solely on the creditworthiness of the debtor is clearly and closely related to a debt host (see Section 8.4.2.3). However, the creditworthiness of a third party is not clearly and closely related to a debt host.</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). The fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>Yes</td>
<td>A credit-risk-related feature that adjusts the payments of a debt host contract meets the definition of a derivative (see Section 8.4.2.4).</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>It depends</td>
<td>Typically, no specific scope exception is available for a credit-risk-related feature that is based on the debtor’s creditworthiness (see Section 8.3.5). However, in some situations the scope exception for financial guarantee contracts may apply (see Section 8.4.2.5).</td>
</tr>
</tbody>
</table>
As shown in the table above, a debtor's determination of whether an embedded credit-risk-related feature must be bifurcated as a derivative tends to focus on whether the feature is considered clearly and closely related to the debt host contract (see Section 8.4.2.3 below) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3). If the credit-risk-related feature is based on the credit risk of a third party, the debtor should also evaluate whether the feature can be net settled (see Section 8.4.2.4) and whether it qualifies for the scope exception for financial guarantee contracts (see Section 8.4.2.5).

### 8.4.2.3 Clearly-and-Closely-Related Analysis

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
</table>
| **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). |

A credit-sensitive payment is considered clearly and closely related to a debt host contract under ASC 815-15-25-46 and 25-47 if it is triggered by, and directionally consistent with, a measure of the debtor's creditworthiness, such as one or more of the following:

- The debtor's failure to pay amounts due on a timely basis (e.g., additional interest on late payments).
- The debtor's failure to comply with credit-risk-related debt covenants (e.g., additional interest that becomes payable if there is a material adverse change in the debtor's creditworthiness).
- A change in the debtor's published credit rating (e.g., additional interest that becomes payable upon a credit rating downgrade).
- A change in observable interest rate spreads over a risk-free interest rate (e.g., U.S. Treasury rates) for debt instruments with similar credit risk (e.g., an interest rate that varies on the basis of observable credit spreads on identical or similar debt securities issued by the debtor or other similar debtors).
- A change in another measure of the debtor's creditworthiness (e.g., a specified interest margin that varies on the basis of a measure of the debtor's working capital).

However, a provision that requires an adjustment on the basis of the creditworthiness of a third party (e.g., the third party's default) is not clearly and closely related to a host debt contract.
Debt contracts often contain provisions that require the debtor to pay additional interest upon the occurrence of an “event of default.” To determine whether such a provision is clearly and closely related to the debt host, the debtor must evaluate how the debt terms define an event of default. The table below discusses common situations that may be described as events of default and whether such triggering events would be considered clearly and closely related to a debt host.

<table>
<thead>
<tr>
<th>Triggering Event</th>
<th>Clearly and Closely Related?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any representation or warranty made by the debtor is not correct</td>
<td>Yes</td>
</tr>
<tr>
<td>The debtor’s failure to perform or comply with financial or nonfinancial covenants</td>
<td>Yes, unless the covenants include items that do not impact the issuer’s credit risk</td>
</tr>
<tr>
<td>The debtor’s bankruptcy or insolvency</td>
<td>Yes</td>
</tr>
<tr>
<td>Cross default on the debtor’s 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 or failure of debtor to maintain loan or collateral documents</td>
<td>Yes</td>
</tr>
<tr>
<td>The debtor’s nonpayment of principal or interest when due</td>
<td>Yes</td>
</tr>
<tr>
<td>Judgments or orders against the debtor exceeding a specific amount</td>
<td>Yes</td>
</tr>
<tr>
<td>Revocation of the debtor’s 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 debtor</td>
<td>Yes</td>
</tr>
<tr>
<td>A change of control of the debtor</td>
<td>No</td>
</tr>
<tr>
<td>Key-person event</td>
<td>Depends on facts and circumstances</td>
</tr>
</tbody>
</table>

**Example 8-9**

**Debt With Interest Rate Adjustment**

Company ABC is rated BBB. Company ABC issues $100 million in 8 percent fixed-rate bonds. The bonds include a provision that requires the interest rate to reset to 10 percent if ABC’s credit rating is downgraded to a single B at any time during the term of the bonds. The embedded derivative that resets the interest rate of the bonds is clearly and closely related to the debt host because it is based on the issuer’s credit rating.

However, if ABC’s bonds include a provision that requires the interest rate to reset to 10 percent if Company XYZ’s (an unrelated party’s) credit rating is downgraded to a single B at any time during the term of the bonds, the reset feature is not clearly and closely related to the debt host.
Chapter 8 — Embedded Derivatives

ASC 815-15

Case A: Credit-Linked Note

55-103 Entity A issues to an investor a fixed-rate, 10-year, $10 million credit-linked note that provides for periodic interest payments and the repayment of principal at maturity. However, upon default of a specified reference security (an Entity X subordinated debt obligation) the redemption value of the note may be zero or there may be some claim to the recovery value of the reference security (depending on the terms of the specific arrangement). Generally, the term reference security refers to the security whose credit rating or default determines the cash flows under a credit derivative. Usually, the terms of credit-linked notes explicitly reference Committee on Uniform Security Identification Procedures (CUSIP) numbers of securities in the marketplace. In an event of default of the specified reference security, there is no recourse to the general credit of the obligor (Entity A). In exchange for accepting the default risk of the reference security, the note entitles the investor to an enhanced yield. The transaction results in the investor selling credit protection and Entity A buying credit protection.

55-104 The credit-linked note includes an embedded credit derivative. The credit risk exposure of the reference security (Entity X) and the risk exposure arising from the creditworthiness of the obligor (Entity A) are not clearly and closely related. Thus, the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the debt host contract and, accordingly, the criterion in paragraph 815-15-25-1(a) is met.

55-105 Paragraph 815-15-25-6 explains that the fair value election for hybrid financial instruments that otherwise would require bifurcation does not apply to hybrid financial instruments that are described in paragraph 825-10-50-8, which include insurance contracts as discussed in Section 944-20-15, other than financial guarantees and investment contracts.

55-106 Consideration should be given to whether the embedded derivative could possibly not be subject to this Topic as a financial guarantee under paragraph 815-10-15-58 and, in that circumstance, the embedded derivative would not warrant bifurcation.

Case M: Credit-Sensitive Bond

55-200 A credit-sensitive bond has a coupon rate of interest that resets based on changes in the issuer’s credit rating.

55-201 A credit-sensitive bond can be viewed as combining a fixed-rate bond with a conditional exchange contract (or option contract) that entitles the investor to a higher rate of interest if the credit rating of the issuer declines. Because the creditworthiness of the debtor and the interest rate on a debt instrument are clearly and closely related, the embedded derivative should not be separated from the host contract.

8.4.2.4 Derivative Analysis

The table below presents an analysis of whether a credit-risk-related embedded feature that could adjust the payments on a debt host contract meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.
As shown in the table above, a credit-risk-related embedded feature that could adjust the payments of a debt host contract on the basis of the debtor's creditworthiness meets the definition of a derivative. Therefore, the analysis of whether such a feature must be bifurcated as a derivative tends to focus on whether the feature is considered clearly and closely related to the debt host contract (see Section 8.4.2.3) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3).

### 8.4.2.5 Scope Exception for Financial Guarantee Contracts

ASC 815-10

15-58 Financial guarantee contracts are not subject to this Subtopic only if they meet all of the following conditions:

a. They provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract, either:
   1. At prespecified payment dates
   2. At accelerated payment dates as a result of either the occurrence of an event of default (as defined in the financial obligation covered by the guarantee contract) or notice of acceleration being made to the debtor by the creditor.

b. Payment under the financial guarantee contract is made only if the debtor's obligation to make payments as a result of conditions as described in (a) is past due.

c. The guaranteed party is, as a precondition in the contract (or in the back-to-back arrangement, if applicable) for receiving payment of any claim under the guarantee, exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

In contrast, financial guarantee contracts are subject to this Subtopic if they do not meet all three criteria, for example, if they provide for payments to be made in response to changes in another underlying such as a decrease in a specified debtor's creditworthiness.
As noted in ASC 815-15-55-106 (see Section 8.4.2.3), a debtor should consider whether an embedded credit derivative in a credit-linked note qualifies for the scope exception for certain financial guarantee contracts in ASC 815-10-15-58. To qualify for this scope exception, the embedded feature must meet all of the conditions in ASC 815-10-15-58. For example, the scope exception is only available if the guaranteed party (i.e., the issuer of the credit-linked note) as a precondition for payment (e.g., a reduction in the contractually required cash flows of the credit-linked note) is contractually required to either (1) hold the third-party debt or (2) be exposed to the risk of nonpayment on the third-party debt through a back-to-back arrangement with another party under which that other party is contractually required to hold the third-party debt. Further, the scope exception is only available if the feature solely reimburses the guaranteed party (i.e., the issuer of the credit-linked note) for overdue payments on the third-party debt. For example, the scope exception is not available if the guarantee payments are made on the basis of (1) events of default other than past-due payments on the third-party debt or (2) changes in the credit rating of the third-party debtor.

8.4.3 Inflation-Indexed Payments

8.4.3.1 Background

This section discusses the analysis of whether an inflation-indexed payment feature embedded in a debt host contract should be separated as a derivative (e.g., inflation-linked bonds). The discussion does not address features that could accelerate the repayment of the outstanding amount of the debt in cash upon the occurrence or nonoccurrence of a specified event (e.g., an acceleration feature that is triggered by a specified measure of inflation). Such features should be evaluated as contingent redemption features (see Section 8.4.4).

8.4.3.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of an inflation-indexed payment feature embedded in a debt host contract. However, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.
### Bifurcation Condition | Condition Met? | Analysis
--- | --- | ---
Not clearly and closely related (see Section 8.3.2) | It depends | The rate of inflation in the economic environment for the currency in which the debt is denominated is clearly and closely related to the debt host unless the feature is leveraged (see Section 8.4.3.3). The rate of inflation in other economic environments is not clearly and closely related to a debt host.
Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3) | It depends | Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). However, the fair value option cannot be elected for debt that contains a separately recognized equity component at inception.
Meets the definition of a derivative (see Section 8.3.4) | Yes | An inflation-indexed payment feature that adjusts the payments of a debt host contract meets the definition of a derivative (see Section 8.4.3.4).
Meets a scope exception (see Section 8.3.5) | No | No specific scope exception is available for inflation-indexed payment features embedded in debt host contracts (see Section 8.3.5).

As shown in the table above, a debtor’s determination of whether an inflation-indexed feature that could adjust the payments of a debt host contract must be bifurcated as a derivative tends to focus on whether the feature is considered clearly and closely related to the debt host contract (see Section 8.4.3.3) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3). Typically, such features meet the definition of a derivative (see Section 8.4.3.4) and are not exempt from the scope of derivative accounting.

#### 8.4.3.3 Clearly-and-Closely-Related Analysis

**ASC 815-15**

**25-50** The interest rate and the rate of inflation in the economic environment for the currency in which a debt instrument is denominated shall be considered to be clearly and closely related. Thus, nonleveraged inflation-indexed contracts (debt instruments, capitalized lease obligations, pension obligations, and so forth) shall not have the inflation-related embedded derivative separated from the host contract.

Under ASC 815-15-25-50, the indexation of principal or interest payments to an inflation rate (e.g., U.S. CPI or U.K. RPI) is considered clearly and closely related to a debt host contract if (1) the inflation rate is appropriate for the economic environment for the currency in which the debt is denominated and (2) the feature is not leveraged (e.g., interest payments that are computed on the basis of two times CPI would not be considered clearly and closely related to a debt host contract). For example, payments indexed to an unleveraged measure of U.S. CPI would be considered clearly and closely related to USD-denominated debt. Conversely, the rate of inflation in a different economic environment (e.g., EUR-denominated debt that has principal or interest payments indexed to U.S. CPI) is not clearly and closely related to the debt host.
Example 8-10

Debt With Embedded Inflation Index Feature

A U.S. company issues U.S. dollar–denominated bonds. There is an embedded inflation index that requires the bond issuer to pay the change in the Mexican CPI every two years. The embedded inflation-indexed derivative is not clearly and closely related to the bond because it is not the rate of inflation of the United States, the economic environment in which the bond was issued. However, if the bond issuer was required to pay the change in U.S. CPI every two years, the embedded derivative would be clearly and closely related and, therefore, would not need to be accounted for separately.

ASC 815-15

Case N: Inflation Bond

55-202 An inflation bond has a contractual principal amount that is indexed to the inflation rate but cannot decrease below par; the coupon rate is typically below that of traditional bonds of similar maturity.

55-203 An inflation bond can be viewed as a fixed-rate bond for which a portion of the coupon interest rate has been exchanged for a conditional exchange contract (or option contract) indexed to the consumer price index, or other index of inflation in the economic environment for the currency in which the bond is denominated, that entitles the investor to payment of additional principal based on increases in the referenced index. Such rates of inflation and interest rates on the debt instrument are considered to be clearly and closely related. Therefore, the embedded derivative should not be separated from the host contract.

8.4.3.4 Derivative Analysis

The table below presents an analysis of whether an inflation-indexed feature that could adjust the cash flows of a debt host contract meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
<td>An inflation-indexed payment feature that could adjust the payments of a debt host contract has both an underlying (i.e., the applicable measure of inflation, such as the change in CPI) and a notional amount (i.e., the amount on which the adjustment is based, such as the debt's outstanding amount) or payment provision (e.g., a fixed cash payment).</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
<td>The initial net investment in an embedded feature is its fair value (i.e., the amount that would need to be paid to acquire the inflation-indexed feature on a stand-alone basis without the host contract). Generally, an inflation-indexed feature has an initial net investment that is smaller than would be required for a direct investment that has the same exposure to changes in the inflation rate (since the investment in the debt host contract does not form part of the initial net investment for the embedded feature).</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net settlement (see Section 8.3.4.4)</td>
<td>Yes</td>
<td>A feature that adjusts the payments of a debt host contract on the basis of an inflation index meets the net settlement condition (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 feature’s notional amount).</td>
</tr>
</tbody>
</table>

As shown in the table above, an inflation-indexed feature embedded in a debt host contract typically meets the definition of a derivative. Therefore, the analysis of whether such a feature must be bifurcated as a derivative tends to focus on whether the feature is considered clearly and closely related to the debt host contract (see Section 8.4.3.3) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3).

8.4.4 Call, Put, and Other Redemption Features

8.4.4.1 Background

Debt contracts often contain features that could permit the issuer to call (or prepay) the outstanding amount or the holder to put (or accelerate the repayment of) the outstanding amount. Debt contracts might also contain features that trigger an acceleration of the due date for the repayment of the debt upon the occurrence or nonoccurrence of a specified event or events (e.g., an event of default or change of control).

8.4.4.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of redemption features embedded in a debt host contract. However, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>It depends</td>
<td>The debtor should evaluate whether the redemption feature is clearly and closely related to the debt host under the four-step decision sequence in ASC 815-15-25-41 (see Section 8.4.4.3).</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). The fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>Yes</td>
<td>A redemption feature embedded in a debt host meets the definition of a derivative irrespective of whether the debt host contract is readily convertible to cash (see Section 8.4.4.4).</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>No</td>
<td>There is no specific scope exception for redemption features embedded in a debt host.</td>
</tr>
</tbody>
</table>
As shown in the table above, a debtor’s determination of whether a redemption feature must be bifurcated as a derivative tends to focus on whether the feature is considered clearly and closely related to the debt host contract (see Section 8.4.4.3 below) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3). Such features meet the definition of a derivative (see Section 8.4.4.4) and are not exempt from the scope of derivative accounting.

8.4.4.3 Clearly-and-Closely-Related Analysis

<table>
<thead>
<tr>
<th>ASC 815-15 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepayable</td>
</tr>
<tr>
<td>Able to be settled by either party before its scheduled maturity.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
ASC 815-15-25-41 and 25-42 address whether embedded call or put options are clearly and closely related to a debt host contract and apply to all features that can accelerate the settlement of a debt instrument whether such acceleration is optional or mandatory and regardless of how such features are described in the debt's contractual terms. ASC 815-15-25-42 identifies four steps that should be performed in the analysis of whether a feature that can accelerate the settlement of a debt instrument is clearly and closely related to a debt host contract:
In practice, a discount or premium that is 10 percent or more is considered “substantial” in the analysis performed under step 3. In determining whether a substantial premium or discount exists, an entity should compare the debt’s initial net carrying amount to the potential payoff if the embedded call, put, or other redemption feature is triggered. Accordingly, an entity should base its analysis on the amount allocated to the debt for accounting purposes rather than the total cash proceeds (e.g., if debt was issued with detachable warrants, the amount allocated to the warrants could cause a discount on the debt). Nevertheless, an entity should not consider a discount that results from one of the following in its determination of whether the debt involves a substantial discount or premium under ASC 815-15-25-42:

- Third-party debt issuance costs that have been deducted from the initial carrying amount (see Section 5.3.3).
- A discount that results from the separation of an embedded derivative under ASC 815-15.
- A discount that results from the separation of an equity component under the Cash Conversion subsections of ASC 470-20 (see Section 7.6.4), because ASC 470-20-15-4 states that the “guidance in the Cash Conversion Subsections does not affect an issuer’s determination under [ASC] 815-15 of whether an embedded feature shall be separately accounted for as a derivative instrument.”
- A discount that results from the separation of an equity component under the guidance on BCFs in ASC 470-20 (see Section 7.6.5).

An entity should consider the payoff of the embedded feature being analyzed in determining whether the debt instrument was issued at a substantial premium or discount. 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 be considered to involve a substantial premium. Similarly, if a debt instrument was issued at 90 percent of par and is redeemable at par, the debt is considered to involve a substantial discount. However, unpaid accrued interest does not form part of the analysis of whether a substantial premium or discount exists.
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>
<tbody>
<tr>
<td>“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.”</td>
<td>• The principal amount is adjusted for changes in the price of gold.</td>
<td>• The payoff is a fixed principal amount plus accrued interest.</td>
</tr>
<tr>
<td></td>
<td>• The principal amount is adjusted for changes in a stock market index.</td>
<td>• The payoff is a fixed principal amount plus a premium that decreases ratably as the instrument approaches maturity.</td>
</tr>
<tr>
<td></td>
<td>• The principal amount is adjusted to reflect changes in inflation rates (e.g., CPI).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The principal amount is adjusted on the basis of the issuer’s earnings or EBITDA.</td>
<td></td>
</tr>
<tr>
<td>“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.”</td>
<td>• Commodity-linked payoff (see Section 8.4.9.3).</td>
<td>• Payoff directly linked to changes in the borrower’s credit rating (see Section 8.4.2.3).</td>
</tr>
<tr>
<td></td>
<td>• Equity-linked payoff (see Section 8.4.7.3), such as debt that is callable by the issuer at par plus 5 percent of the change in S&amp;P 500.</td>
<td>• Nonleveraged inflation-indexed contracts where the inflation rate is in the economic environment for the currency in which the debt is denominated (see Section 8.4.3.3).</td>
</tr>
<tr>
<td></td>
<td>• Payoff linked to a credit risk exposure that is different from the borrower’s credit risk exposure (see Section 8.4.2.3).</td>
<td></td>
</tr>
<tr>
<td>“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” (see Section 8.4.1).</td>
<td>• Fixed-rate debt issued at a 12 percent discount to par and contingently puttable at par.</td>
<td>• Debt puttable at par issued at a 6 percent discount to par.</td>
</tr>
<tr>
<td></td>
<td>• Fixed-rate debt issued at par that is contingently puttable for 110 percent of par.</td>
<td>• Debt issued at a 3 percent discount to par that is callable upon an IPO at par plus accrued and unpaid interest.</td>
</tr>
<tr>
<td>“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” (see Section 8.4.1).</td>
<td>•Convertible debt with a redemption feature that permits the investor to put the debt if an IPO occurs.</td>
<td>• The embedded option is exercisable at any time.</td>
</tr>
<tr>
<td></td>
<td>• Debt with a redemption option that is exercisable by either the investor or the issuer upon a change in control.</td>
<td>• The embedded option is exercisable at the anniversary date of the issuance of the debt.</td>
</tr>
<tr>
<td></td>
<td>• Debt with a redemption option that is exercisable upon a change in interest of at least 150 basis points.</td>
<td></td>
</tr>
</tbody>
</table>
As noted in steps 2, 3, and 4 of the decision sequence in ASC 815-15-25-42, an entity might be required to consider the applicability of ASC 815-15-25-26 to an embedded call, put, or other redemption feature. ASC 815-15-25-26 applies 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” (see Section 8.4.1.3). 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 at the issuer) would always have a second underlying (the occurrence or nonoccurrence of the specified event). The existence of this second underlying would exclude such a contract from the scope of ASC 815-15-25-26 unless the event is 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 (see Section 8.4.1.3.2).

### Example 8-11

**Debt That Is Puttable 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>
Example 8-12

**Interest Make-Whole Premium That Becomes Payable Upon Exercise of Call Option**

Entity X has issued a debt security, which includes a call option that permits X to prepay the outstanding amount of principal and accrued interest at any time before the debt's maturity. If X calls the debt security before its maturity date, it is required to also pay an interest make-whole premium equal to the present value of the debt's remaining interest cash flows discounted at a fixed spread over the current U.S. Treasury rate as of the date on which the debt is settled. However, X could not be required to pay an interest make-whole premium in excess of 5 percent of the principal amount.

The interest make-whole premium is considered an integral component of the call option; it is not a distinct embedded feature that requires separate evaluation under ASC 815-15 (see Section 8.2.3). When assessing whether the call option is clearly and closely related to its host, the issuer first should look to the four-step decision sequence in ASC 815-15-25-42.

<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 security issued at par is callable at par plus an interest make-whole premium that may not exceed 5 percent of the principal amount.</td>
<td>Yes. The amount paid upon settlement is adjusted on the basis of changes in the then-current U.S. Treasury rate. The calculation of the interest make-whole premium includes the U.S. Treasury rate. The payoff is not, however, indexed to an underlying other than interest rates or credit risk.</td>
<td>No. The debt was issued at par and the interest make-whole premium cannot exceed 5 percent of the principal amount.</td>
<td>N/A. Analysis is not required because the answer to the question in step 3 is no (i.e., no substantial discount or premium).</td>
<td>ASC 815-15-25-26 applies since the interest make-whole premium is indexed to an interest rate. Under ASC 815-15-25-26(a), there is no circumstance in which the investor would not contractually recover its initial investment if the issuer exercises the call option because the repayment amount will exceed the principal amount, and the debt was issued at par. ASC 815-15-25-26(b) does not apply. ASC 815-15-25-37 states that this condition does not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor. The embedded call option, including the interest make-whole provision, is clearly and closely related to the debt host.</td>
</tr>
</tbody>
</table>
ASC 815-15

The following table demonstrates the application of the four-step decision sequence in paragraph 815-15-25-42 for determining whether call options and put options that can accelerate the settlement of debt instruments should be considered to be clearly and closely related to the debt host contract under the criterion in paragraph 815-15-25-1(a).

<table>
<thead>
<tr>
<th>Instrument</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>1. Debt that is issued at a substantial discount is callable at any time during its 10-year term. If the debt is called, the investor receives the par value of the debt plus any unpaid and accrued interest.</td>
<td>No.</td>
<td>Yes.</td>
<td>No.</td>
<td>The embedded call option is clearly and closely related to the debt host contract because the payoff is not indexed, and the call option is not contingently exercisable.</td>
</tr>
<tr>
<td>2. Debt that is issued at par is callable at any time during its term. If the debt is called, the investor receives the greater of the par value of the debt or the market value of 100,000 shares of XYZ common stock (an unrelated entity).</td>
<td>Yes, based on an equity price.</td>
<td>N/A. Analysis not required.</td>
<td>N/A. Analysis not required.</td>
<td>The embedded call option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.</td>
</tr>
<tr>
<td>3. Debt that is issued at par is puttable if the Standard and Poor's S&amp;P 500 Index increases by at least 20 percent. If the debt is put, the investor receives the par amount of the debt adjusted for the percentage increase in the S&amp;P 500.</td>
<td>Yes, based on an equity index (S&amp;P 500).</td>
<td>N/A. Analysis not required.</td>
<td>N/A. Analysis not required.</td>
<td>The embedded put option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.</td>
</tr>
<tr>
<td>4. Debt that is issued at a substantial discount is puttable at par if London Interbank Offered Rate (LIBOR) either increases or decreases by 150 basis points.</td>
<td>No.</td>
<td>Yes.</td>
<td>Yes, contingent on a movement of LIBOR of at least 150 basis points.</td>
<td>The put option is not clearly and closely related to the debt host contract because the debt was issued at a substantial discount and the put option is contingently exercisable.</td>
</tr>
<tr>
<td>5. Debt that is issued at a substantial discount is puttable at par in the event of a change in control.</td>
<td>No.</td>
<td>Yes.</td>
<td>Yes, contingent on a change in control.</td>
<td>The put option is not clearly and closely related to the debt host contract because the debt was issued at a substantial discount and the put option is contingently exercisable.</td>
</tr>
</tbody>
</table>
### ASC 815-15 (continued)

(Table continued)

<table>
<thead>
<tr>
<th>Instrument</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>6. Zero coupon debt is issued at a substantial discount and is callable in the event of a change in control. If the debt is called, the issuer pays the accreted value (calculated per amortization table based on the effective interest rate method).</td>
<td>No.</td>
<td>Yes.</td>
<td>Yes, contingent on a change in control, but since the debt is callable at accreted value, the call option does not accelerate the repayment of principal.</td>
<td>The call option is clearly and closely related to the debt host contract. Although the debt was issued at a substantial discount and the call option is contingently exercisable, the call option does not accelerate the repayment of principal because the debt is callable at the accreted value.</td>
</tr>
<tr>
<td>7. Debt that is issued at par is puttable at par in the event that the issuer has an initial public offering.</td>
<td>No.</td>
<td>No.</td>
<td>N/A. Analysis not required.</td>
<td>The embedded put option is clearly and closely related to the debt host contract because the debt was issued at par (not at a substantial discount) and is puttable at par. Paragraph 815-15-25-26 does not apply.</td>
</tr>
<tr>
<td>8. Debt that is issued at par is puttable if the price of the common stock of Entity XYZ (an entity unrelated to the issuer or investor) changes by 20 percent. If the debt is put, the investor will be repaid based on the value of Entity XYZ's common stock.</td>
<td>Yes, based on an equity price (price of Entity XYZ's common stock).</td>
<td>N/A. Analysis not required.</td>
<td>N/A. Analysis not required.</td>
<td>The embedded put option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.</td>
</tr>
<tr>
<td>9. Debt is issued at a slight discount and is puttable if interest rates move 200 basis points. If the debt is put, the investor will be repaid based on the S&amp;P 500.</td>
<td>Yes, based on an equity index (S&amp;P 500).</td>
<td>N/A. Analysis not required.</td>
<td>N/A. Analysis not required.</td>
<td>The embedded put option is not clearly and closely related to the debt host contract because the payoff is based on an equity index.</td>
</tr>
</tbody>
</table>

### 8.4.4.4 Derivative Analysis

#### 8.4.4.4.1 General

The table below presents an analysis of whether a redemption feature embedded in a debt host contract meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.
As shown in the table above, a redemption feature embedded in a debt host contract meets the definition of a derivative. Therefore, the analysis of whether such a feature must be bifurcated as a derivative tends to focus on whether the feature is considered clearly and closely related to the debt host contract (see Section 8.4.4.3) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3).

8.4.4.4.2 Net Settlement Analysis

ASC 815-10

**Net Settlement of a Debt Instrument Through Exercise of an Embedded Put Option or Call Option**

15-107 The potential settlement of the debtor's obligation to the creditor that would occur upon exercise of a put option or call option embedded in a debt instrument meets the net settlement criterion as discussed beginning in paragraph 815-10-15-100 because neither party is required to deliver an asset that is associated with the underlying. Specifically:

a. The debtor does not receive an asset when it settles the debt obligation in conjunction with exercise of the put option or call option.

b. The creditor does not receive an asset associated with the underlying.

15-108 The guidance in the preceding paragraph shall be applied under both of the following circumstances:

a. When applying paragraph 815-15-25-1(c) to a put option or call option (including a prepayment option) embedded in a debt instrument

b. When analyzing the net settlement criterion (see guidance beginning in paragraph 815-10-15-100) for a freestanding call option held by the debtor on its own debt instrument and for a freestanding put option issued by the debtor on its own debt instrument.
ASC 815-10-15-109 indicate that the potential settlement of a debtor’s obligation to the creditor that would occur upon the exercise of a put option or call option (including a prepayment option) embedded in a debt instrument meets the net settlement condition in ASC 815-10-15-100, which states that “neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount.”

Accordingly, a call, put, or other redemption feature that is embedded in a debt host meets the net settlement characteristic in the definition of a derivative irrespective of whether the debt host contract is readily convertible to cash. For instance, such a feature is considered to meet the net settlement characteristic even if it is embedded in a loan or debt security that does not have an observable price. Further, a call, put, or other redemption feature embedded in a debt host meets the net settlement characteristic even if it is settled in a form other than cash. Traditionally, the settlement of a debt obligation upon the exercise of a put or call results in the creditor’s receipt of cash in exchange for tendering the debt obligation. However, in some circumstances, the debtor either is required or has the option to settle the redemption by delivering a number of shares of its own stock with a value equal to a predetermined dollar amount. An embedded redemption feature in a hybrid financial instrument with a debt host that may be settled with the issuer’s shares always meet the criteria for net settlement under the guidance on put or call options in debt host contracts in ASC 815-10-15-107 (see also Section 8.4.7.2.5). The guidance in ASC 815-10-15-107 through 15-109 does not apply to calls, puts, and other redemption features that are embedded in equity host contracts.

Example 8-13

Notes That Are Automatically Converted Into Shares Upon a Qualifying Equity Offering

Company XYZ issues $1 million of notes to an investor group. According to the terms of the notes, XYZ is required to pay interest semiannually at a rate of 8 percent per annum. Principal on the notes is due at maturity, which is two years after issuance. Upon a qualifying equity offering (one in which XYZ raises at least $10 million of equity), the notes are automatically converted into shares sold in the qualifying equity offering. The conversion price equals 80 percent of the price per share of the qualifying equity offering. For example, if XYZ issued $10 million of Series D preferred stock at $10 per share, the notes would be converted into Series D preferred stock at $8 per share.

The automatic conversion upon a qualifying equity offering is economically a contingent redemption of the notes for $1.25 million. However, the investors do not receive $1.25 million in cash; rather, the redemption feature is settled in shares of XYZ with a value of $1.25 million.

The redemption feature would not be considered clearly and closely related to the debt host because it is a contingent redemption and involves a significant premium relative to the amount paid by the investors — $1.25 million compared with $1 million (see ASC 815-15-25-40). Assuming that the debt is not remeasured at fair value with changes in fair value recognized in earnings, XYZ would be required to bifurcate the redemption option if a separate instrument with the same terms would be subject to derivative accounting under ASC 815. Such a redemption feature that meets the net settlement condition would be subject to derivative accounting under ASC 815.
Example 8-13 (continued)

In the evaluation of the net settlement condition under ASC 815-10-15-107(b), the assets being delivered to the holder of the debt instrument are shares of the issuer, which are not associated with any underlying because the value of the shares to be delivered is a fixed dollar amount. In other words, even though the shares are related to the event that triggers redemption (i.e., the shares delivered are the same shares issued in the qualifying equity offering) and an event is considered an underlying, the holder is indifferent to changes in value of any of the equity shares of the issuer in the time between the issuance of the debt and the triggering of the redemption feature because the holder will receive a fixed dollar amount once the redemption is triggered. Therefore, with respect to the condition in ASC 815-10-15-107(b), the shares are not associated with any underlying, regardless of whether the underlying shares are readily convertible to cash. Thus, the net settlement condition is met and the embedded redemption feature related to the automatic conversion upon a qualifying equity offering must be bifurcated from the host contract and accounted for as a derivative liability.

8.4.5 Term Extension Features

8.4.5.1 Background

Term extension features embedded in a debt host contract include those that give either party the right to extend the debt’s remaining term or automatically extend the term upon the occurrence or a specified event.

8.4.5.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of a term extension feature embedded in a debt host contract. However, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>It depends</td>
<td>A term extension feature is not clearly and closely related to a debt host unless the interest rate is concurrently reset to a current market rate and the debt initially did not involve a significant discount (see Section 8.4.5.3).</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). However, the fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>It depends</td>
<td>The evaluation of whether a term extension feature meets the definition of a derivative depends on whether it meets the net settlement characteristic in the definition of a derivative (see Section 8.4.5.4).</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>Generally, yes</td>
<td>A term extension feature embedded in a debt host contract often qualifies for the loan commitment scope exception (see Section 8.4.5.5). However, this scope exception is not available if the term extension option is held by the creditor.</td>
</tr>
</tbody>
</table>

As shown in the table above, a term extension feature in a debt host would not be bifurcated if (1) the feature is considered clearly and closely related to the debt host contract (see Section 8.4.5.3), (2) the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3), (3) the feature does not meet the definition of a derivative (see Section 8.4.5.4), or (4) the feature meets the scope exception for loan commitments (see Section 8.4.5.5).
8.4.5.3 Clearly-and-Closely-Related Analysis

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-44</strong> 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.</td>
</tr>
</tbody>
</table>

Under ASC 815-15-25-44, a term extension feature is clearly and closely related to a debt host only if (1) the interest rate is adjusted to the approximate current market rate of interest for the extended term at the time the term is extended and (2) the debt did not initially involve a significant discount.

Example 8-14

**Debt With Extension Option**

Company XYZ issues five-year, variable-rate debt that pays three-month LIBOR plus 250 basis points on a quarterly basis. At the end of five years, XYZ has an option to extend the debt for another three years and, if the option is exercised, XYZ will continue to pay three-month LIBOR plus 250 basis points for the extended term.

Although the debt continues to vary on the basis of three-month LIBOR if the term of the debt is extended, the interest rate does not reset to current market rates because the credit spread is not adjusted. At the end of the original five-year term, the current market rate for an issuer with the creditworthiness of XYZ may be different than three-month LIBOR plus 250 basis points (e.g., the current market rate for XYZ debt could be LIBOR plus 750 basis points), even if the creditworthiness of XYZ has not changed. Therefore, because XYZ has the option to extend the maturity of the debt significantly and the interest rate in its entirety does not reset to market, the term-extending option is not clearly and closely related to the debt host.

Example 8-15

**Bonds With Extension Options**

Entity ABC issues two series of bonds that are publicly traded. One bond has a five-year term and a 6 percent fixed coupon rate and grants the bondholder an option to extend the debt for another three years at a 6 percent fixed interest rate. The second bond has an eight-year term and a 6 percent fixed coupon rate and grants the bondholder an option to put the debt back to ABC at the end of five years. Although these two bonds are economically similar, they are analyzed differently under ASC 815. The first bond is analyzed as a five-year debt host contract with an embedded term extension feature. The second bond is analyzed as an eight-year debt host contract with an embedded put option.

The term-extending option in the first bond extends the maturity of the debt significantly but does not reset the interest rate to a market rate. The term-extending option, therefore, is not clearly and closely related to the debt host and may need to be bifurcated from the host contract and accounted for separately if it meets the other criteria in ASC 815-15-25-1. The embedded put option in the second bond would not be evaluated under the guidance on term extension options. Instead it would be evaluated under the guidance on embedded put options (see Section 8.4.4).
8.4.5.4 Derivative Analysis

The table below presents an analysis of whether a term extension feature embedded in a debt host contract meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
<td>A term extension feature in a debt host contract has both an underlying (interest rates and, if applicable, the occurrence or nonoccurrence of any exercise contingency) and a notional amount (the principal amount subject to extension) or payment provision.</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
<td>The initial net investment in an embedded feature is its fair value (i.e., the amount that would need to be paid to acquire the term extension feature on a stand-alone basis without the debt host contract). Generally, a term extension feature has an initial net investment that is smaller than would be required for a direct investment in the amount of debt that is subject to the term extension (since the investment in the debt host contract does not form part of the initial net investment for the embedded feature).</td>
</tr>
<tr>
<td>Net settlement (see Section 8.3.4.4)</td>
<td>It depends</td>
<td>Typically, the debtor would evaluate whether the debt contract that will be extended is readily convertible to cash (see below).</td>
</tr>
</tbody>
</table>

Generally, the analysis of whether an embedded term extension feature meets the definition of a derivative focuses on whether the feature meets the net settlement characteristic. If a term extension feature does not contain an explicit net settlement provision or a market mechanism to facilitate net settlement (both of which would be uncommon), the evaluation depends on whether the instrument whose maturity is being extended is readily convertible to cash (e.g., publicly traded debt that may be sold in increments that can be rapidly absorbed by the market without significantly affecting the price). If the underlying debt is not readily convertible to cash, the embedded term extension feature should not be bifurcated as a derivative because it does not permit net settlement and therefore does not meet the definition of a derivative.

8.4.5.5 Scope Exception for Loan Commitments

Because a term extension feature is a legally binding commitment to extend the term of the debt on the basis of prespecified terms and conditions, it is economically equivalent to a loan commitment for the term extension period. Therefore, the loan commitment scope exception in ASC 815-10-15-69 through 15-71 (see Section 8.4.6.5) can be applied to a term extension feature that gives the debtor the unilateral option to extend the maturity of nonconvertible debt.

In a typical loan commitment, a potential creditor agrees to the terms under which a potential debtor may borrow money. However, the potential debtor is not legally obligated to borrow money under those terms or even from that creditor. Therefore, if the creditor has the option to extend the maturity of the debt, the instrument is not the equivalent of a loan commitment and thus would not qualify for the exception.
8.4.6 Embedded Loan Commitments (Including PIK Interest Features)

8.4.6.1 Background

A credit facility or tranche debt financing might include both an initial term loan and commitments to obtain additional term loans on specified dates in the future. Further, some debt instruments contain a PIK interest feature, which requires or permits the debtor to pay interest in the form of additional debt that has the same terms as the original debt instrument. In substance, a PIK interest feature is a loan commitment since it permits or requires the debtor to issue additional debt on specified terms to settle future interest payments.

Note that the discussion in this section only applies if the debtor has determined that the debt and the loan commitments represent one combined unit of account (see Section 3.3). If the loan commitments represent separate units of account (e.g., the commitments are legally detachable and separately exercisable from the debt), the loan commitments should not be evaluated as features embedded in the debt but as freestanding loan commitments (see Section 2.3.3).

8.4.6.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of a loan commitment embedded in a debt host contract. However, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>It depends</td>
<td>A loan commitment whose features are not clearly and closely related to a debt instrument would not be clearly and closely related to the debt host contract (see Section 8.4.6.3).</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). However, the fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>It depends</td>
<td>The evaluation of whether a loan commitment meets the definition of a derivative depends on whether it meets the net settlement characteristic in the definition of a derivative (see Section 8.4.6.4).</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>It depends</td>
<td>The debtor should evaluate whether the commitment qualifies for the loan commitment scope exception (see Section 8.4.6.5). This scope exception is not available if the commitment is held by the potential creditor or investor.</td>
</tr>
</tbody>
</table>

8.4.6.3 Clearly-and-Closely-Related Analysis

A loan commitment is not clearly and closely related to a debt host contract if it includes features that are not clearly and closely related to a debt instrument. For example, a commitment to issue both debt and warrants on the debtor’s equity shares or a commitment to issue debt that is convertible into the debtor’s equity shares would not be clearly and closely related to a debt host contract since the debtor’s stock price is not clearly and closely related to a debt host.
### 8.4.6.4 Derivative Analysis

The table below presents an analysis of whether a loan commitment embedded in a debt host contract meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
<td>A loan commitment embedded in a debt host contract has both an underlying (interest rates and, if applicable, the occurrence or nonoccurrence of any exercise contingency and other underlyings) and a notional amount (the committed amount of debt) or payment provision.</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
<td>The initial net investment in an embedded feature is its fair value (i.e., the amount that would need to be paid to acquire the loan commitment on a stand-alone basis without the debt host contract). Generally, an embedded loan commitment feature has an initial net investment that is smaller than the committed amount of debt.</td>
</tr>
<tr>
<td>Net settlement (see Section 8.3.4.4)</td>
<td>It depends</td>
<td>The debtor should evaluate whether the debt that would be funded upon settlement of the loan commitment is readily convertible to cash (see below).</td>
</tr>
</tbody>
</table>

Generally, an analysis of whether an embedded loan commitment meets the definition of a derivative focuses on whether it meets the net settlement characteristic in the definition of a derivative (see Section 8.3.4.4). If the loan commitment does not contain an explicit net settlement provision or a market mechanism to facilitate net settlement (both of which would be uncommon), the evaluation of whether the feature meets the net settlement characteristic depends on whether the debt that would be funded is readily convertible to cash (e.g., publicly traded debt that may be sold in increments that can be rapidly absorbed by the market without significantly affecting the price). If the underlying debt is not readily convertible to cash, the embedded loan commitment should not be bifurcated as a derivative because it does not permit net settlement and therefore does not meet the definition of a derivative.

### 8.4.6.5 Scope Exception for Loan Commitments

ASC 815-10-15-69 through 15-71 contain a scope exception related to the derivative accounting requirements in ASC 815 for “a commitment to originate a loan” for the holder of the commitment (i.e., the potential borrower). This scope exception applies irrespective of whether (1) the commitment is contingent and (2) the loan is revolving or nonrevolving. Commitments to issue debt securities (e.g., tranche debt issuances) also qualify for this scope exception. ASC 310-10-20 defines a loan as a “contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor’s statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable.” We informally discussed with members of the SEC staff the application of this scope exception to commitments to issue debt securities. The staff concurred that it is appropriate to apply the loan commitment exception to an entity’s commitment to receive funds in exchange for the initial issuance of a debt security that will be an obligation of the entity.
In a typical loan commitment, the potential creditor writes an option to the potential debtor that permits the potential debtor to obtain debt on prespecified terms at its request. Therefore, the loan commitment scope exception does not apply to an option written by the potential debtor to the potential creditor under which the potential creditor could force the potential debtor to enter into a loan but does not give the potential debtor a right to elect to borrow money from the potential creditor.

ASC 815 does not clearly address whether the scope exception for loan commitments is available if the loan to be funded contains an embedded feature that will need to be bifurcated as a derivative once the loan is funded. It may therefore be prudent for an entity to further evaluate whether the loan commitment meets the definition of a derivative in ASC 815. If the loan commitment does not meet the net settlement characteristic in the definition of a derivative (e.g., it requires delivery of an underlying loan that is not readily convertible to cash and the commitment cannot otherwise be net settled), the debtor may conclude the loan commitment should not be accounted for as a derivative even if the scope exception for loan commitments is considered inapplicable.

8.4.7 Equity Features (Including Conversion, Exchange, and Indexed Features)

8.4.7.1 Background
This section discusses the analysis of whether equity features, including features that involve conversion of debt into the debtor’s equity shares or third-party stock as well as payment features indexed to a stock price or stock price index, should be separated from a debt host contract and accounted for as derivatives under ASC 815-15.

8.4.7.2 Bifurcation Analysis

8.4.7.2.1 General
The bifurcation analysis differs depending on whether the equity feature economically is an equity conversion feature settleable in the debtor’s equity shares (see Section 8.4.7.2.2 below), an exchange feature settleable in the equity shares of a third party (see Section 8.4.7.2.3), or a payment feature indexed to a stock price or stock price index (see Section 8.4.7.2.4). The analysis of a feature that economically represents a share-settled redemption or indexation feature whose monetary value does not vary on the basis of a stock price is discussed separately (see Section 8.4.7.2.5). Such features do not represent conversion or exchange options since their monetary value is not indexed to the fair value of the shares delivered upon settlement.

8.4.7.2.2 Equity Conversion Feature
Debt instruments often contain features that require or permit the debt to be converted into the debtor’s equity shares. The table below presents an overview of the bifurcation analysis of equity conversion features embedded in a debt host contract that are settleable in the debtor’s equity shares, including the shares of a substantive consolidated entity. The table does not apply to an embedded feature that economically represents a share-settled redemption or indexation feature whose monetary value does not vary on the basis of the debtor’s stock price (see Section 8.4.7.2.5). Further, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.
As shown in the table above, the analysis of whether an equity conversion feature should be bifurcated from a debt host contract under ASC 815-15 usually centers on whether the feature meets (1) the net settlement characteristic in the definition of a derivative (see Sections 8.4.7.4 and 8.4.7.5) 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 (see Section 8.4.7.6).

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 scope exception for own equity may change if the entity authorizes the issuance of additional shares (see Section 5.4 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*). The accounting analysis might also change if a conversion feature becomes readily convertible to cash because a market develops for the underlying shares (see Section 8.4.7.5.6). The issuer must monitor such changes on an ongoing basis.

**ASC 815-15**

**Case U: Convertible Debt Instrument**

**55-217** In a convertible debt instrument, an investor receives a below-market interest rate and receives the option to convert its debt instrument into the equity of the issuer at an established conversion rate. The terms of the conversion require that the issuer deliver shares of stock to the investor.

**55-218** This instrument essentially contains a call option on the issuer's stock. Under the provisions of this Subtopic, the accounting by the issuer and investor can differ. The issuer’s accounting depends on whether a separate instrument with the same terms as the embedded written option would be a derivative instrument pursuant to Section 815-10-15. Because the option is indexed to the issuer’s own stock and a separate instrument with the same terms would be classified in stockholders’ equity in the statement of financial position, the written option is not considered to be a derivative instrument for the issuer under paragraph 815-10-15-74(a) and should not be separated from the host contract.
In contrast, if the terms of the conversion allow for a cash settlement rather than delivery of the issuer's shares at the investor's option, the exception in paragraph 815-10-15-74(a) for the issuer does not apply because the contract would not be classified in stockholders' equity in the issuer's statement of financial position. In that circumstance, the issuer should separate the embedded derivative from the host contract and account for it pursuant to the provisions of this Subtopic because both of the following conditions exist:

a. An option based on the entity's stock price is not clearly and closely related to an interest-bearing debt instrument.

b. The option would not be considered an equity instrument of the issuer.

Similarly, if the convertible debt is indexed to another entity's publicly traded common stock, the issuer should separate the embedded derivative from the host contract and account for it pursuant to the provisions of this Subtopic because both of the following conditions exist:

a. An option based on another entity's stock price is not clearly and closely related to an investment in an interest-bearing note.

b. The option would not be considered an equity instrument of the issuer.

The exception in paragraph 815-10-15-74 does not apply to the investor's accounting. Therefore, in both circumstances described, the investor should separate the embedded option contract from the host contract and account for the embedded option contract pursuant to the provisions of this Subtopic because the option contract is based on the price of another entity's equity instrument and thus is not clearly and closely related to an investment in an interest-bearing note. However, if the terms of conversion do not allow for a cash settlement and if the common stock delivered upon conversion is privately held (that is, is not readily convertible to cash), the embedded derivative would not be separated from the host contract because it would not meet the criteria for net settlement as discussed beginning in paragraph 815-10-15-99.

The description of the accounting for an equity conversion feature in a debt host in ASC 815-15-55-217 through 55-221 contains certain unstated, simplified assumptions that are not always applicable. Therefore, an entity cannot rely solely on those paragraphs in its accounting analysis for an equity conversion feature and must also consider other guidance in ASC 815. In particular, it is assumed in ASC 815-15-55-218 that the debtor can apply the scope exception in ASC 815-10-15-74(a) to the conversion feature, but this is not always an appropriate assumption (see Section 8.4.7.6). Further, it is assumed in ASC 815-15-55-219 that the hybrid instrument is not accounted for at fair value, with changes in fair value recognized in net income. However, if the hybrid instrument is accounted for at fair value, with changes in fair value recognized in earnings, bifurcation would not be appropriate (see Section 8.3.3).
8.4.7.2.3 Exchange Feature Involving Third-Party Stock

A debt instrument may contain a feature that requires or permits its exchange into the shares of a third party. For example, 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 similar to those of an investment in convertible debt, the issuer should not analyze the exchange feature as an equity conversion feature that potentially could qualify for the scope exception for certain contracts on own equity since it is not settled in the debtor's equity shares.

In consolidated financial statements, a debt instrument issued by a parent entity or its subsidiary that is exchangeable into the 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, the exchange feature would be analyzed as an equity conversion feature involving the company's own stock under ASC 815-15 (see Section 8.4.7.2.2).

In the subsidiary's separate financial statements, the parent's equity is not considered equity of the subsidiary. Therefore, a debt instrument that is issued by a subsidiary and exchangeable into the parent's equity shares would not be analyzed as an instrument that is convertible into the issuer's equity shares 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 instrument would be analyzed as a debt instrument that is convertible into the issuer's equity shares, as discussed above.

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 analyzed as an exchange feature that is settleable in third-party stock under ASC 815-15.
The table below presents an overview of the bifurcation analysis of a feature that requires or permits a debt contract to be exchanged for shares of stock issued by a third party (other than shares of stock issued by a substantive consolidated entity). The table does not apply to a feature that economically represents a share-settled redemption or indexation feature whose monetary value does not vary on the basis of the third party’s stock price (see Section 8.4.7.2.5). An entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>Yes</td>
<td>The changes in the fair value of an equity interest are not clearly and closely related to a debt host (see Section 8.4.7.3.2).</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). However, the fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>It depends</td>
<td>The debtor should evaluate whether the feature meets the net settlement characteristic in the definition of a derivative (see Sections 8.4.7.4 and 8.4.7.5).</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>No</td>
<td>There is no specific scope exception available for features that involve the exchange of debt for shares issued by a third party (other than shares of stock issued by a substantive consolidated entity).</td>
</tr>
</tbody>
</table>

As shown in the table above, a debtor’s determination of whether an exchange feature settleable in third-party stock must be bifurcated as a derivative tends to focus on whether the feature meets the net settlement characteristic in the definition of a derivative (see Sections 8.4.7.4 and 8.4.7.5) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3). Such features are not clearly and closely related to a debt host contract (see Section 8.4.7.3.2) and are not exempt from the scope of derivative accounting.

8.4.7.2.4 Equity-Indexed Payment Features

The table below presents an overview of the bifurcation analysis of an equity-indexed payment feature embedded in a debt host contract (e.g., a debt contract with principal or interest payments indexed to the S&P 500 Index). An entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.
As shown in the table above, an equity-indexed payment feature typically must be bifurcated as a derivative unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3).

### 8.4.7.2.5 Share-Settled Redemption or Indexation Features

A financial instrument may contain a term that is described as an equity conversion or exchange feature but economically represents a share-settled redemption or indexation provision whose monetary value does not vary on the basis of a stock price or stock price index. The number of equity shares 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 an equity conversion or exchange feature, the issuer should not analyze it as such since it does not have the economic payoff profile of an equity conversion or exchange 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. (If the instrument is issued in the form of an equity share [e.g., preferred stock], the issuer should also evaluate whether the feature results in the requirement to classify the instrument as a liability under ASC 480-10; see Chapter 6 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*.)

**Example 8-16**

**Debt Settleable for Variable Number of Shares Upon a Qualified Equity Financing**

A debt instrument includes a feature that must be “converted” into the debtor’s common stock upon a qualified equity financing. The conversion price is defined as (1) the outstanding amount of principal and interest divided by (2) the price of a share of common stock in the qualified equity offering. Although the contract refers to the feature as a conversion feature and it must be settled in shares of common stock, the instrument should not be analyzed as a debt instrument with an equity conversion feature because the monetary value of the shares delivered upon conversion is unrelated to the fair value of the issuer’s equity shares. Instead, under ASC 815-15, this feature should be evaluated as a contingent redemption option; it would not be evaluated as a conversion feature even though it is settled in the debtor’s equity shares (see Section 8.4.4).
Example 8-17

**Debt Indexed to S&P 500 Index**

A debt instrument with a principal amount of $1 million contains a "conversion" feature that requires the issuer to settle, at the holder's option, the instrument in a variable number of common shares equal in value to $1 million adjusted for changes in the S&P 500 Index. Under ASC 815-15, this feature would not be analyzed as an equity conversion feature. Instead, it should be evaluated as a payment feature indexed to the S&P 500 Index (see Section 8.4.7.2.4).

Note that a share-settled redemption or indexation feature meets the net settlement characteristic in the definition of a derivative irrespective of whether the shares that will be delivered upon settlement are readily convertible to cash. Because the monetary amount of the obligation does not depend on the share price, neither party is required to deliver an asset (1) that is associated with the underlying and (2) whose principal amount, stated amount, face value, number of shares, or other denomination is equal to the notional amount (see Section 8.4.4.4.2).

**8.4.7.3 Clearly-and-Closely-Related Analysis**

8.4.7.3.1 Equity Conversion or Exchange Features

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-51</strong> The changes in fair value of an equity interest and the interest rates on a debt instrument are not clearly and closely related. Thus, for a debt security that is convertible into a specified number of shares of the debtor's common stock or another entity's common stock, the embedded derivative (that is, the conversion option) shall be separated from the debt host contract and accounted for as a derivative instrument provided that the conversion option would, as a freestanding instrument, be a derivative instrument subject to the requirements of this Subtopic. (For example, if the common stock was not readily convertible to cash, a conversion option that requires purchase of the common stock would not be accounted for as a derivative instrument.) That accounting applies only to the holder (investor) if the debt is convertible to the debtor's common stock because, under paragraph 815-10-15-74(a), a separate option with the same terms would not be a derivative instrument for the issuer.</td>
</tr>
</tbody>
</table>

A conversion or exchange feature whose value varies on the basis of changes in the equity instruments that would be issued upon conversion is not clearly and closely related to a debt host because the economic characteristics and risks of an equity instrument differ from the economic characteristics and risks of a debt instrument. Such a feature is not clearly and closely related to a debt host irrespective of whether it is considered indexed to the entity's own equity under ASC 815-40 (see Section 8.4.7.6).

The accounting for an equity conversion feature in a debt host in ASC 815-15-25-51 is premised on certain unstated, simplified assumptions that are not always applicable. Therefore, an entity cannot rely solely on those paragraphs in its accounting analysis for an equity conversion feature and must also consider other guidance in ASC 815. For example, it is assumed in the second sentence in ASC 815-15-25-51 that the hybrid instrument is not accounted for at fair value, with changes in fair value recognized in net income. However, if the hybrid instrument is accounted for at fair value, with changes in fair value recognized in earnings, bifurcation would not be required (see Section 8.3.3). Further, it is assumed in the final sentence in ASC 815-15-25-51 that the equity conversion feature meets the scope exception in ASC 815-10-15-74(a), which is not always an appropriate assumption (see Section 8.4.7.6).
8.4.7.3.2 Equity-Indexed Payment Feature

**ASC 815-15**

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.

**Example 7: Clearly and Closely Related Criterion — Characterizing a Debt Host**

55-117 This Example illustrates the application of the clearly and closely related criterion in paragraph 815-15-25-1(a) to the determination of what is the host contract and what is the embedded derivative composing the illustrative hybrid instrument. This Example has the following assumptions:

a. An entity (Entity A) issues a 5-year debt instrument with a principal amount of $1,000,000 indexed to the stock of an unrelated publicly traded entity (Entity B).

b. At maturity, the holder of the instrument will receive the principal amount plus any appreciation or minus any depreciation in the fair value of 10,000 shares of Entity B, with changes in fair value measured from the issuance date of the debt instrument.

c. No separate interest payments are made.

d. The market price of Entity B shares to which the debt instrument is indexed is $100 per share at the issuance date.

55-118 The instrument is not itself a derivative instrument because it requires an initial net investment equal to the notional amount. The host contract is a debt instrument because the instrument has a stated maturity and because the holder has none of the rights of a shareholder, such as the ability to vote the shares and receive distributions to shareholders. The embedded derivative is an equity-based derivative that has as its underlying the fair value of the stock of Entity B. As a result of the host instrument being a debt instrument and the embedded derivative having an equity-based return, the embedded derivative is not clearly and closely related to the host contract and must be separated from the host contract and accounted for as a derivative by both the issuer and the holder of the hybrid instrument. (Paragraph 815-15-25-4 allows for a fair value election for hybrid financial instruments that otherwise would require bifurcation. Hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedging instrument in a Topic 815 hedging relationship.)

**Example 8: Clearly and Closely Related Criterion — Debt Instrument Incorporating Equity-Based Return**

55-119 This Example illustrates the application of the clearly and closely related criterion in paragraph 815-15-25-1(a). Even though an overall hybrid instrument that provides for repayment of principal may include a return based on the market price (the underlying as defined) of XYZ Corporation common stock, the host contract does not involve any existing or potential residual interest rights (that is, rights of ownership) and thus would not be an equity instrument. The host contract would instead be considered a debt instrument, and the embedded derivative that incorporates the equity-based return would not be clearly and closely related to the host contract.

**Case H: Equity-Indexed Note**

55-189 An equity-indexed note is a bond for which the return of interest, principal, or both is tied to a specified equity security or index, for instance, the Standard and Poor's 500 S&P 500 Index. This instrument may contain a fixed or varying coupon rate and may place all or a portion of principal at risk.
ASC 815-15 (continued)

55-190 An equity-indexed note essentially combines an interest-bearing instrument with a series of forward exchange contracts or option contracts. Often, a portion of the coupon interest rate is, in effect, used to purchase options that provide some form of floor on the potential loss of principal that would result from a decline in the referenced equity index. Because forward or option contracts for which the underlying is an equity index are not clearly and closely related to an investment in an interest-bearing note, those embedded derivatives should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Subtopic.

Case I: Variable Principal Redemption Bond

55-191 A variable principal redemption bond’s principal redemption value at maturity depends on the change in an underlying index over a predetermined observation period. A typical circumstance would be a bond that guarantees a minimum par redemption value of 100 percent and provides the potential for a supplemental principal payment at maturity as compensation for the below-market rate of interest offered with the instrument.

55-192 Assume that a supplemental principal payment will be paid to the investor, at maturity, if the final S&P 500 closing value (determined at a specified date) is less than its initial value at date of issuance and the 10-year U.S. Treasury constant maturities is greater than 2 percent as of a specified date. In all circumstances, the minimum principal redemption will be 100 percent of par.

55-193 A variable principal redemption bond essentially combines an interest-bearing investment with an option that is purchased with a portion of the bond’s coupon interest payments. Because the embedded option entitling the investor to an additional return is partially contingent on the S&P 500 index closing above a specified amount, it is not clearly and closely related to an investment in a debt instrument. Therefore, the embedded option should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Subtopic.

Case P: Specific Equity-Linked Bond

55-207 A specific equity-linked bond pays a coupon slightly below that of traditional bonds of similar maturity; however, the principal amount is linked to the stock market performance of an equity investee of the issuer. The issuer may settle the obligation by delivering the shares of the equity investee or may deliver the equivalent fair value in cash.

55-208 A specific equity-linked bond can be viewed as combining an interest-bearing instrument with, depending on its terms, a series of forward exchange contracts or option contracts based on an equity instrument. Often, a portion of the coupon interest rate is used to purchase options that provide some form of floor on the loss of principal due to a decline in the price of the referenced equity instrument. The forward or option contracts do not qualify for the exception in paragraph 815-10-15-59(b) because the shares in the equity investee owned by the issuer meet the definition of a financial instrument. Because forward or option contracts for which the underlying is the price of a specific equity instrument are not clearly and closely related to an investment in an interest-bearing note, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Subtopic.

In a manner similar to an equity conversion or exchange feature (see Section 8.4.7.3.1), a feature that adjusts the contractual payments on the basis of a stock price or stock price index is not clearly and closely related to a debt host. Accordingly, a contractual provision in a debt host that involve payments that are indexed to a stock price or stock price index must be bifurcated as a derivative if the other bifurcation conditions in ASC 815-15-25-1 are also met.
Example 8-18

Debt With Principal Amount That Is Indexed to Stock Price

Company ABC issues $100 million of five-year debt. The debt pays an annual coupon of 6 percent and is indexed to the price of 1 million shares of Company XYZ’s common stock. Company XYZ is listed on the New York Stock Exchange and, on the date on which the debt is issued, its stock price is $100 per share. At debt maturity, if XYZ’s common stock has appreciated in value to $200 per share, ABC will pay $200 million; however, if the value of XYZ’s stock has depreciated to $50 per share at maturity, ABC will pay $50 million.

Although the return on the debt is linked to an equity instrument (XYZ’s stock), the host contract is considered a debt host because the instrument is legal form debt with a stated maturity and no shareholder rights. The embedded equity forward is not clearly and closely related to the debt host; therefore, the embedded derivative must be bifurcated and accounted for at fair value unless the issuer elects to measure the entire hybrid financial instrument at fair value, with changes in fair value recognized in earnings.

If ABC was required to deliver XYZ’s shares to the investor instead of adjusting the amount of cash paid at maturity of the debt, ABC would need to assess whether XYZ’s shares are readily convertible to cash (i.e., whether the 1 million shares significantly affect the market price of XYZ) to determine whether the embedded equity forward meets the definition of a derivative instrument. For more information, see Sections 8.4.7.4 and 8.4.7.5).

8.4.7.4 Derivative Analysis

8.4.7.4.1 Equity Conversion or Exchange Feature

The table below presents an analysis of whether an equity conversion or exchange feature meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
<td>An equity conversion or exchange feature has both an underlying (the fair value of the equity instruments that would be issued upon conversion and, if applicable, the occurrence or nonoccurrence of any exercise contingency) and a notional amount (the number of shares that would be issued upon conversion).</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
<td>The initial net investment in an embedded feature is its fair value (i.e., the amount that would need to be paid to acquire the equity conversion feature on a stand-alone basis without the host contract). Generally, an equity conversion or exchange feature has an initial net investment that is smaller than would be required for a direct investment that has the same exposure to changes in the stock price (since the investment in the debt host contract does not form part of the initial net investment for the embedded feature).</td>
</tr>
</tbody>
</table>
Generally, an analysis of whether an equity conversion or exchange feature meets the definition of a derivative focuses on whether it meets the net settlement characteristic (see Section 8.4.7.5).

### 8.4.7.4.2 Equity-Indexed Payment Feature

The table below presents an analysis of whether an equity-indexed payment feature meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
<td>An equity-indexed payment feature has both an underlying (a stock price or stock price index) and a notional amount (the debt’s principal amount) or payment provision.</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
<td>The initial net investment in an embedded feature is its fair value (i.e., the amount that would need to be paid to acquire the equity-indexed payment feature on a stand-alone basis without the host contract). Generally, an equity-indexed payment feature has an initial net investment that is smaller than would be required for a direct investment that has the same exposure to changes in the stock price or stock price index (since the investment in the debt host contract does not form part of the initial net investment for the embedded feature).</td>
</tr>
<tr>
<td>Net settlement (see Section 8.3.4.4)</td>
<td>Yes</td>
<td>A feature that adjusts the payments of a debt host contract on the basis of a stock price or stock price index meets the net settlement condition since 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 feature's notional amount. (If the feature must be settled by delivery of the underlying shares of stock, however, the considerations in Section 8.4.7.5 apply.)</td>
</tr>
</tbody>
</table>

As shown in the table above, an equity-indexed feature embedded in a debt host contract typically meets the definition of a derivative. Because such a feature is not clearly and closely related to a debt host and does not qualify for any scope exception, it must be bifurcated as a derivative unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3).
8.4.7.5 **Net Settlement Analysis**

8.4.7.5.1 **Background**

An equity conversion or exchange feature (see Sections 8.4.7.2.2 and 8.4.7.2.3) embedded in a debt host contract does not meet the definition of a derivative instrument on a stand-alone basis unless it satisfies the net settlement characteristic. In evaluating whether an embedded conversion or exchange feature can be explicitly net settled, the entity should consider all of the debt instrument’s terms (e.g., redemption and liquidation features). Different considerations apply in the following situations:

- The feature may be settled in cash (see Section 8.4.7.5.2).
- The feature may be settled net in shares (see Section 8.4.7.5.3).
- The feature requires physical settlement in stock that is not restricted (see Section 8.4.7.5.4).
- The feature requires physical settlement in restricted stock (see Section 8.4.7.5.5).

These considerations do not apply to an equity-indexed payment feature that adjusts the payments of a debt host contract on the basis of a stock price or stock price index unless it is settled by delivery of the feature’s underlying shares of stock. Such a feature meets the net settlement characteristic irrespective of whether it is settled in cash or other assets (including those that are not readily convertible to cash) since neither party is required to deliver an asset whose principal amount, stated amount, face value, number of shares, or other denomination is equal to the feature’s notional amount (see Section 8.4.7.4.2).

8.4.7.5.2 **Features That May Be Settled in Cash Upon Settlement**

A conversion or exchange feature that can be settled in cash at either party’s election meets the net settlement characteristic since the feature is explicitly net settled. Often convertible debt instruments specify that, upon conversion, the issuer or the investor may elect to have the instrument settle in an amount of 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. For example, conversion features embedded in convertible instruments in the form of Instruments A, B, C, or X (see Section 7.6.4.1) meet the net settlement characteristic in the definition of a derivative irrespective of whether the underlying shares are readily convertible to cash, since such instruments either require or permit the conversion value or the conversion spread to be settled in cash.

In other cases, a convertible 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 embedded conversion option). The conversion option, by its terms, may only be settled physically. However, the redemption feature permits net cash settlement of the conversion option; therefore, the net settlement characteristic is met.
8.4.7.5.3 Net-Share-Settled Features

ASC 815-10

15-102 The net settlement criterion as described in paragraph 815-10-15-83(c) and related paragraphs in this Subsection is met if a contract provides for net share settlement at the election of either party. Therefore, if either counterparty could net share settle a contract, then it would be considered to have the net settlement characteristic of a derivative instrument regardless of whether the net shares received were readily convertible to cash as described in paragraph 815-10-15-119 or were restricted for more than 31 days as discussed beginning in paragraph 815-10-15-130. While this conclusion applies to both investors and issuers of contracts, issuers of those net share settled contracts shall consider whether such contracts qualify for the scope exception in paragraph 815-10-15-74(a). See Example 5 (paragraph 815-10-55-90).

Example 5: Net Settlement Under Contract Terms — Net Share Settlement

55-90 This Example illustrates the concept of net share settlement. Entity A has a warrant to buy 100 shares of the common stock of Entity X at $10 a share. Entity X is a privately held entity. The warrant provides Entity X with the choice of settling the contract physically (gross 100 shares) or on a net share basis. The stock price increases to $20 a share. Instead of Entity A paying $1,000 cash and taking full physical delivery of the 100 shares, the contract is net share settled and Entity A receives 50 shares of stock without having to pay any cash for them. (Net share settlement is sometimes described as a cashless exercise.) The 50 shares are computed as the warrant's $1,000 fair value upon exercise divided by the $20 stock price per share at that date.

A conversion or exchange feature that can be settled net in shares meets the net settlement characteristic even if the shares are not readily convertible to cash. For example, a convertible debt instrument might specify that, upon conversion, the outstanding amount of principal and interest will be settled in cash, and the conversion spread in shares. In this scenario, the conversion feature is net share settled and meets the net settlement characteristic of a derivative.

8.4.7.5.4 Physically Settled Features

ASC 815-10

15-130 A security that is publicly traded but for which the market is not very active is readily convertible to cash if the number of shares or other units of the security to be exchanged is small relative to the daily transaction volume. That same security would not be readily convertible if the number of shares to be exchanged is large relative to the daily transaction volume.

A conversion or exchange feature that is embedded in a debt host and that requires physical settlement in equity shares upon settlement meets the net settlement characteristic if the shares that would be issued upon settlement are readily convertible to cash (see Section 8.3.4.4.4). A share of a company’s stock is considered to be readily convertible to cash if the share price is quoted in an active market that can rapidly absorb the smallest increment of shares available for exchange under the contract without any significant impact on the quoted price. Typically, shares traded in a public market are readily convertible to cash unless the smallest number of shares that can be exchanged under the contract is large relative to the daily trading volume of the shares (see below) or the costs of converting the shares into cash (e.g., sales commissions on the quoted price) are in excess of 10 percent of the stock price at the inception of the contract (see Section 8.3.4.4.4). However, shares are not considered readily convertible to cash if the sale or transfer of the issued shares is restricted for a period of 32 days or more from the date on which a conversion feature is exercised (see Section 8.4.7.5.5).
Example 7: Net Settlement — Readily Convertible to Cash — Effect of Daily Transaction Volumes

55-99 The following Cases illustrate consideration of the relevance of daily transaction volumes to the characteristic of net settlement in deciding whether, from the investor’s perspective, the convertible bond contains an embedded derivative that must be accounted for separately:

a. Single bond with multiple conversion options (Case A)
b. Multiple bonds each having single conversion option (Case B).

55-100 The Cases illustrate that the form of the financial instrument is important; paragraph 815-10-15-123 explains that individual instruments cannot be combined for evaluation purposes to circumvent compliance with the criteria beginning in paragraph 815-10-15-119. Further, paragraph 815-10-15-111(c) explains that contracts shall be evaluated on an individual basis, not on an aggregate-holdings basis.

Case A: Single Bond with Multiple Conversion Options

55-101 Investor A holds a convertible bond classified as an available-for-sale security under Topic 320. The bond has all of the following additional characteristics:

a. It is not exchange-traded and can be converted into common stock of the debtor, which is traded on an exchange.
b. It has a face amount of $100 million and is convertible into 10 million shares of common stock.
c. It may be converted in full or in increments of $1,000 immediately or at any time during the next 2 years.
d. If it were converted in a $1,000 increment, Investor A would receive 100 shares of common stock.

55-102 Assume further that the market condition for the debtor's stock is such that up to 500,000 shares of its stock can be sold rapidly without the share price being significantly affected.

55-103 The embedded conversion option meets the criteria in paragraph 815-10-15-83(a) through (b) but does not meet the criteria in paragraphs 815-10-15-100 and 815-10-15-110, in part because the option is not traded and it cannot be separated and transferred to another party.

55-104 It is clear that the embedded equity conversion feature is not clearly and closely related to the debt host instrument.

55-105 The bond may be converted in $1,000 increments and those increments, by themselves, may be sold rapidly without significantly affecting price, in which case the criteria discussed beginning in paragraph 815-10-15-119 would be met. However, if the holder simultaneously converted the entire bond, or a significant portion of the bond, the shares received could not be readily converted to cash without incurring a significant block discount.

55-106 From Investor A’s perspective, the conversion option should be accounted for as a compound embedded derivative in its entirety, separately from the debt host, because the conversion feature allows the holder to convert the convertible bond in 100,000 increments and the shares converted in each increment are readily convertible to cash under the criteria discussed beginning in paragraph 815-10-15-119. Investor A need not determine whether the entire bond, if converted, could be sold without affecting the price.
ASC 815-10 (continued)

55-107 Because the $100 million bond is convertible in increments of $1,000, the convertible bond is essentially embedded with 100,000 equity conversion options, each with a notional amount of 100 shares. Each of the equity conversion options individually has the characteristic of net settlement discussed beginning in paragraph 815-10-15-119 because the 100 shares to be delivered are readily convertible to cash. Because the equity conversion options are not clearly and closely related to the host debt instrument, they must be separately accounted for. However, because an entity cannot identify more than 1 embedded derivative that warrants separate accounting, the 100,000 equity conversion options must be bifurcated as a single compound derivative. (Paragraphs 815-15-25-7 through 25-10 say an entity is not permitted to account separately for more than one derivative feature embedded in a single hybrid instrument.)

55-108 There is a substantive difference between a $100 million convertible debt instrument that can be converted into equity shares only at one time in its entirety and a similar instrument that can be converted in increments of $1,000 of tendered debt; the analysis of the latter should not presume equality with the former.

Case B: Multiple Bonds Each Having Single Conversion Option

55-109 Investor B has 100,000 individual $1,000 bonds that each convert into 100 shares of common stock. Assume those bonds are individual instruments but they were issued concurrently to Investor B.

55-110 From Investor B's perspective, the individual bonds each contain an embedded derivative that must be separately accounted for. Each individual bond is convertible into 100 shares, and the market would absorb 100 shares without significantly affecting the price of the stock.

As discussed in Section 8.3.4.4, the evaluation of whether an embedded feature is readily convertible to cash is performed on the basis of the smallest increment in which it can be settled under its contractual terms. ASC 815-10-55-101 through 55-108 contain an illustration of a $100 million bond that is convertible into 10 million shares of stock when the market can rapidly absorb 500,000 shares without a significant effect on the share price. If the terms of that bond permit the holder to convert the bond in $1,000 increments for 100 shares each, the embedded conversion feature would be considered readily convertible to cash under ASC 815-10-55-119 even though the aggregate number of shares that would be issued if the holder converted the entire bond could not be readily converted to cash without incurring a significant block discount. If, under the above terms, the bond could only be converted at one time in its entirety, the equity conversion feature would not meet the net settlement characteristic since the stock market could not rapidly absorb 500,000 shares without a significant effect on the share price.

8.4.7.5.5 Features Physically Settled in Restricted Stock

ASC 815-10

15-131 Shares of stock in a publicly traded entity to be received upon the exercise of a stock purchase warrant do not meet the characteristic of being readily convertible to cash if both of the following conditions exist:

a. The stock purchase warrant is issued by an entity for only its own stock (or stock of its consolidated subsidiaries).

b. The sale or transfer of the issued shares is restricted (other than in connection with being pledged as collateral) for a period of 32 days or more from the date the stock purchase warrant is exercised.
15-132 Restrictions imposed by a stock purchase warrant on the sale or transfer of shares of stock that are received from the exercise of that warrant issued by an entity for other than its own stock (whether those restrictions are for more or less than 32 days) do not affect the determination of whether those shares are readily convertible to cash. The accounting for restricted stock to be received upon exercise of a stock purchase warrant shall not be analogized to any other type of contract.

15-133 Newly outstanding shares of common stock in a publicly traded company to be received upon exercise of a stock purchase warrant cannot be considered readily convertible to cash if, upon issuance of the shares, the sale or transfer of the shares is restricted (other than in connection with being pledged as collateral) for more than 31 days from the date the stock purchase warrant is exercised (not the date the warrant is issued), unless the holder has the power by contract or otherwise to cause the requirement to be met within 31 days of the date the stock purchase warrant is exercised.

15-134 In contrast, if the sale of an actively traded security is restricted for 31 days or less from the date the stock purchase warrants are exercised, that limitation is not considered sufficiently significant to serve as an impediment to considering the shares to be received upon exercise of those stock purchase warrants as readily convertible to cash.

15-135 The guidance that a restriction for more than 31 days prevents the shares from being considered readily convertible to cash applies only to stock purchase warrants issued by an entity for its own shares of stock, in which case the shares being issued upon exercise are newly outstanding (including issuance of treasury shares) and are restricted with respect to their sale or transfer for a specified period of time beginning on the date the stock purchase warrant is exercised.

15-136 However, even if the sale or transfer of the shares is restricted for 31 days or less after the stock purchase warrant is exercised, an entity still must evaluate both of the following criteria:
   a. Whether an active market can rapidly absorb the quantity of stock to be received upon exercise of the warrant without significantly affecting the price
   b. Whether the other estimated costs to convert the stock to cash are expected to be not significant. (The assessment of the significance of those conversion costs shall be performed only at inception of the contract.)

Thus, the guidance in paragraph 815-10-15-122 shall be applied to those stock purchase warrants with sale or transfer restrictions of 31 days or less on the shares of stock.

15-137 If the shares of an actively traded common stock to be received upon exercise of the stock purchase warrant can be reasonably expected to qualify for sale within 31 days of their receipt, such as may be the case under SEC Rule 144, Selling Restricted and Control Securities, or similar rules of the SEC, any initial sales restriction is not an impediment to considering those shares as readily convertible to cash, as that phrase is used in paragraph 815-10-15-119. (However, a restriction on the sale or transfer of shares of stock that are received from an entity other than the issuer of that stock through the exercise of another option or the settlement of a forward contract is not an impediment to considering those shares readily convertible to cash, regardless of whether the restriction is for a period that is more or less than 32 days from the date of exercise or settlement.)
The shares that would be delivered upon the settlement of a conversion feature are not considered readily convertible to cash if (1) their sale or transfer is restricted for a period of 32 days or more from the date on which the feature is exercised and (2) the holder does not have “the power by contract or otherwise to cause the requirement to be met within 31 days.” If the shares to be delivered are actively traded and can reasonably be expected to qualify for sale within 31 days, however, they may be considered readily convertible to cash even if their sale or transfer is restricted (see ASC 815-10-15-137). Note, however, that the guidance on restricted stock does not apply to exchange features that restrict the sale or transfer of third-party stock that would be delivered upon settlement of an exchange feature (see ASC 815-10-15-132).

8.4.7.5.6 Ongoing Assessment

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case B: Initial Public Offering Makes Shares Readily Convertible to Cash After Contract Inception</td>
</tr>
<tr>
<td>55-87 A nontransferable forward contract on a nonpublic entity's stock that provides only for gross physical settlement is generally not a derivative instrument because the net settlement criteria are not met. If the entity, at some point in the future, accomplishes an initial public offering of its shares and the original contract is still outstanding, the shares to be delivered would be considered to be readily convertible to cash (assuming that the shares under the contract could be rapidly absorbed in the market without significantly affecting the price).</td>
</tr>
</tbody>
</table>

| Case C: Increased Trading Activity Makes Shares Readily Convertible to Cash After Contract Inception |
| 55-88 A nontransferable forward contract on a public entity's stock provides for delivery on a single date of a significant number of shares that, at the inception of the contract, would significantly affect the price of the public entity's stock in the market if sold within a few days. As a result, the contract does not satisfy the readily-convertible-to-cash criterion. However, at some later date, the trading activity of the public entity's stock increases significantly. Upon a subsequent evaluation of whether the shares are readily convertible to cash, the number of shares to be delivered would be minimal in relation to the new average daily trading volume such that the contract would then satisfy the net settlement characteristic. |

| Case D: Delisting Makes Shares Not Readily Convertible to Cash After Contract Inception |
| 55-89 A nontransferable forward contract on a public entity's stock meets the net settlement criteria (as discussed beginning in paragraph 815-10-15-119) in that, at inception of the contract, the shares are expected to be readily convertible to cash when delivered under the contract. Assume that there is no other way that the contract meets the net settlement criteria. The public entity subsequently becomes delisted from the stock exchange, thus causing the shares to be delivered under the contract to no longer be readily convertible to cash. |

An entity should continually reassess whether an embedded feature meets the net settlement characteristic in the definition of a derivative (see Section 8.3.4.4.5). ASC 815-10-55-87 through 55-89 highlight that such reassessment might be required for the stock underlying a contract upon its IPO, a change in its market activity, or its delisting.
8.4.7.6 **Scope Exception for Certain Own Equity Contracts**

8.4.7.6.1 **General**

**ASC 815-10**

15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

a. Contracts issued or held by that reporting entity that are both:
   1. Indexed to its own stock
   2. Classified in stockholders’ equity in its statement of financial position.

15-75A For purposes of evaluating whether a financial instrument meets the scope exception in paragraph 815-10-15-74(a)(1), a down round feature shall be excluded from the consideration of whether the instrument is indexed to the entity’s own stock.

15-76 Temporary equity is considered stockholders’ equity for purposes of the scope exception in paragraph 815-10-15-74(a) even if it is required to be displayed outside of the permanent equity section.

15-78 Paragraph 815-40-25-39 explains that, for purposes of evaluating under this Subtopic whether an embedded derivative indexed to an entity’s own stock would be classified in stockholders’ equity if freestanding, the additional considerations necessary for equity classifications beginning in paragraph 815-40-25-7 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).

**ASC 815-15**

25-14 The criterion in paragraph 815-15-25-1(c) is not met if the separate instrument with the same terms as the embedded derivative would be classified as a liability (or an asset in some circumstances) under the provisions of Topic 480 but would be classified in stockholders’ equity absent the provisions in that Topic. For purposes of analyzing the application of paragraph 815-10-15-74(a) to an embedded derivative as though it were a separate instrument, paragraphs 480-10-25-4 through 25-14 shall be disregarded. Those embedded features are analyzed by applying other applicable guidance.

25-15 Paragraph 815-40-25-39 states that, 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 additional considerations necessary for equity classification beginning in paragraph 815-40-25-7 do not apply if the hybrid contract is a conventional convertible debt instrument (see paragraph 815-40-25-41) 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). However, paragraph 815-40-25-40 states that those additional considerations do apply when an issuer is evaluating whether any embedded derivative other than those discussed in paragraph 815-40-25-39 is an equity instrument and thereby excluded from the scope of this Subtopic.

The determination of whether an embedded equity conversion feature meets the scope exception in ASC 815-10-15-74(a) 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 (see Section 8.4.7.6.2) and, if so, whether the feature meets additional equity classification conditions in ASC 815-40-25 (see Section 8.4.7.6.5). This section provides a brief overview of those requirements. For a comprehensive discussion of the application of this guidance, see Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*. 
8.4.7.6.2 Determining Whether the Feature Is Indexed to Own Equity Under ASC 815-40-15

**ASC 815-40**

15-7 An entity shall evaluate whether an equity-linked financial instrument (or embedded feature), as discussed in paragraphs 815-40-15-5 through 15-8 is considered indexed to its own stock within the meaning of this Subtopic and paragraph 815-10-15-74(a) using the following two-step approach:

a. Evaluate the instrument's contingent exercise provisions, if any.

b. Evaluate the instrument's settlement provisions.

One of the conditions that must be met for an equity conversion feature to qualify for the exception related to derivative accounting in ASC 815-10-15-74(a) is that it must be indexed to the entity's own stock under ASC 815-40-15. An entity performs a two-step analysis to determine whether this condition has been satisfied:

- **Step 1** — Evaluate whether the feature contains any exercise contingencies and, if so, whether they disqualify the feature from being considered indexed to the entity's own equity (see Section 8.4.7.6.3).

- **Step 2** — Assess whether the settlement terms preclude the feature from being considered indexed to the entity's own equity (see Section 8.4.7.6.4).
**8.4.7.6.3 Step 1 of Indexation Analysis**

**ASC 815-40 — Glossary**

**Exercise Contingency**

A provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies.

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**ASC 815-40**

15-7A An exercise contingency shall not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on either of the following:

a. An observable market, other than the market for the issuer's stock (if applicable)

b. An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer; earnings before interest, taxes, depreciation, and amortization of the issuer; net income of the issuer; or total equity of the issuer).

If the evaluation of Step 1 (this paragraph) does not preclude an instrument from being considered indexed to the entity's own stock, the analysis shall proceed to Step 2 (see paragraph 815-40-15-7C).
The following provisions are examples of exercise contingencies:

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exercise condition</td>
<td>A provision that affects whether the conversion feature becomes exercisable.</td>
<td>A conversion feature that becomes exercisable upon an IPO.</td>
</tr>
<tr>
<td>Settlement condition</td>
<td>A provision that affects whether a conversion feature is settled.</td>
<td>A conversion feature that is contingent on whether revenue has exceeded a specified threshold.</td>
</tr>
<tr>
<td>Acceleration provision</td>
<td>A provision that accelerates the timing of either the entity's or the counterparty's ability to exercise the conversion feature or that accelerates the timing of its settlement.</td>
<td>The counterparty's right to exercise the conversion feature is accelerated upon a merger event, tender offer, hedging disruption, loss of stock borrow, nationalization, or delisting.</td>
</tr>
<tr>
<td>Extension provision</td>
<td>A provision that extends the timing of either the entity's or the counterparty's ability to exercise the conversion feature or extends the timing of its settlement.</td>
<td>A provision that extends the expiration date of a conversion feature upon an IPO.</td>
</tr>
<tr>
<td>Deferral provision</td>
<td>A provision that defers the timing of either the entity's or the counterparty's ability to exercise the conversion feature or defers the timing of its settlement.</td>
<td>A provision that delays the counterparty's ability to exercise a conversion feature if the entity lacks sufficient registered shares or that defers settlement if the counterparty's ownership of shares exceeds a specified level or the counterparty needs time to unwind related hedges.</td>
</tr>
<tr>
<td>Termination provision</td>
<td>A provision that results in the conversion feature's termination (also sometimes called &quot;cancellation,&quot; &quot;forfeiture,&quot; or &quot;knock-out&quot; provision).</td>
<td>A provision that terminates the conversion feature upon a change in control, IPO, or insolvency.</td>
</tr>
</tbody>
</table>

Some, but not all, conversion features contain exercise contingencies. The mere passage of time is not considered an exercise contingency, nor is a contingency that affects the calculation of the settlement amount of an instrument if the contingency does not alter the availability or timing of settlement (e.g., the occurrence of a specified event that affects the strike price of an equity conversion feature that was currently exercisable).

Exercise contingencies that are based on an observable market or an observable index preclude an equity conversion feature from being considered indexed to an entity's own equity unless they are based on either of the following:

- The market for the issuer's stock, such as the following:
  - A provision that permits the instrument to be converted if the entity's stock price exceeds a certain dollar amount (a market price trigger).
  - A provision that permits the instrument to be converted into the entity's equity shares if the instrument trades for an amount that is less than a specified percentage (e.g., 98 percent) of its if-converted value (a parity provision).
• An index calculated solely by reference to the issuer’s own operations, such as sales of at least $100 million.

An exercise contingency that is based on something other than an observable market or observable index does not preclude an equity conversion feature from being considered indexed to an entity’s own equity under step 1 of the indexation analysis.

The following table contains additional examples of exercise contingencies and their evaluation under step 1 of the indexation analysis:

<table>
<thead>
<tr>
<th>Exercise Contingencies That Do Not Preclude Equity Classification</th>
<th>Exercise Contingencies That Preclude Equity Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock price of the issuer.</td>
<td>Stock market index (e.g., S&amp;P 500).</td>
</tr>
<tr>
<td>Stock price of a consolidated subsidiary that is a substantive entity.</td>
<td>Commodity price (e.g., gold, natural gas, or oil).</td>
</tr>
<tr>
<td>Revenue, net income, or EBITDA of the issuer.</td>
<td>Foreign currency rate or index.</td>
</tr>
<tr>
<td>Net assets of the issuer.</td>
<td>Interest rate or index (e.g., LIBOR).</td>
</tr>
<tr>
<td>Revenue, net income, or EBITDA of a consolidated subsidiary that is a substantive entity.</td>
<td>CPI.</td>
</tr>
<tr>
<td>A change in control or merger involving the issuer.</td>
<td>The relationship between the stock price of the issuer and a stock market index.</td>
</tr>
<tr>
<td>An IPO of the issuer.</td>
<td>The relationship between (1) the issuer’s revenue, net income, or EBITDA and (2) the revenue, net income, or EBITDA of a competitor company.</td>
</tr>
<tr>
<td>An exchange listing or filing of a registration statement by the issuer.</td>
<td></td>
</tr>
<tr>
<td>Delisting of the issuer.</td>
<td></td>
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<tr>
<td>An offering of additional securities by the issuer.</td>
<td></td>
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<tr>
<td>A stock split or other dilutive event carried out by the issuer.</td>
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<tr>
<td>Extraordinary dividends.</td>
<td></td>
</tr>
<tr>
<td>The issuer’s settlement of another outstanding security of the issuer (e.g., pursuant to exercise of a call option by the issuer or a conversion by the investor).</td>
<td></td>
</tr>
<tr>
<td>Cost of stock borrow on the entity’s stock (including loss of stock borrow and increased cost of stock borrow).</td>
<td></td>
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<tr>
<td>Nationalization.</td>
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<tr>
<td>Insolvency.</td>
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</tr>
<tr>
<td>Change in law (e.g., a change in law that makes it illegal to be a party to the contract).</td>
<td></td>
</tr>
<tr>
<td>Hedging disruption or increased cost of hedging related to the entity’s shares.</td>
<td></td>
</tr>
<tr>
<td>Counterparty’s level of ownership of the entity’s shares.</td>
<td></td>
</tr>
<tr>
<td>Event of default.</td>
<td></td>
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<tr>
<td>Market disruption event (e.g., extended closure of stock exchange).</td>
<td></td>
</tr>
<tr>
<td>A parity provision (convertible instruments only).</td>
<td></td>
</tr>
<tr>
<td>The credit rating of the issuer.</td>
<td></td>
</tr>
</tbody>
</table>
For a comprehensive discussion of step 1 of the indexation analysis under ASC 815-40-15, see Section 4.2 of Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity*.

### 8.4.7.6.4 Step 2 of Indexation Analysis

<table>
<thead>
<tr>
<th><strong>ASC 815-40</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-7C</strong> An instrument (or embedded feature) shall be considered indexed to an entity's own stock if its settlement amount will equal the difference between the following:</td>
</tr>
<tr>
<td>a. The fair value of a fixed number of the entity's equity shares</td>
</tr>
<tr>
<td>b. A fixed monetary amount or a fixed amount of a debt instrument issued by the entity.</td>
</tr>
</tbody>
</table>

For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity shall be considered indexed to the entity's own stock.

**15-7D** An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) shall still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares.

**15-7E** A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including all of the following:

a. Strike price of the instrument  
b. Term of the instrument  
c. Expected dividends or other dilutive activities  
d. Stock borrow cost  
e. Interest rates  
f. Stock price volatility  
g. The entity's credit spread  
h. The ability to maintain a standard hedge position in the underlying shares.

Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) shall be commercially reasonable.

**15-7F** An instrument (or embedded feature) shall not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. An instrument (or embedded feature) shall not be considered indexed to the entity's own stock if either:

a. The instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares.  
b. The instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed in the preceding paragraph in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares.
ASC 815-40 (continued)

15-7G Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in the fair value of an equity-linked instrument and changes in the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock.

15-7H Some equity-linked financial instruments contain provisions that provide an entity with the ability to unilaterally modify the terms of the instrument at any time, provided that such modification benefits the counterparty. For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2, such provisions do not affect the determination of whether an instrument (or embedded feature) is considered indexed to an entity's own stock.

If, after performing step 1 of the indexation analysis, an entity concludes that an equity conversion feature's exercise contingency provisions (if any) do not preclude a conclusion that the feature is indexed to the entity's own stock, the entity must perform step 2 to evaluate the instrument's settlement terms. Under step 2, an equity conversion feature is considered indexed to the entity's own stock if either of the following two conditions is met:

- The equity conversion feature is a “fixed-for-fixed” forward or option on equity shares. That is, the feature's settlement amount will always equal the difference between (1) the fair value of a fixed number of the entity's equity shares and (2) a fixed monetary amount denominated in the reporting entity's functional currency.
- The equity conversion feature is not fixed for fixed, but the only variables that could affect the feature's settlement amount are inputs used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares.
Most equity conversion features contain provisions that adjust the conversion terms upon the occurrence of certain events. In applying step 2, an entity is required to consider any potential settlement adjustment provisions regardless of the likelihood of the occurrence of the associated event. Certain adjustments will disqualify the feature from being considered indexed to the entity's own equity; therefore, the scope exception in ASC 815-10-15-74(a) may not be applied.

There are two types of inputs that may adjust the settlement amount of an equity conversion feature:

- **An explicit input** is an underlying (other than the occurrence or nonoccurrence of a specified event) that could affect the settlement amount (i.e., the exercise price or forward price, or the number of equity shares used to calculate the settlement amount). Examples of explicit inputs include a specific interest rate, security price, commodity price, foreign exchange rate, inflation rate, credit rating, prepayment index, or other index or indexes of specified prices or rates.

- **An implicit input** is an assumption about the occurrence or nonoccurrence of a specified event that could affect the settlement amount (i.e., the exercise price or forward price or the number of equity shares used to calculate the settlement amount). For example, there may be an implicit assumption in the pricing of the feature that no dilutive event affecting the underlying equity securities will occur (e.g., stock split). Other examples of implicit inputs include the occurrence or nonoccurrence of the following events:
  - An IPO or a subsequent offering of securities by the issuer.
  - A tender offer for the securities of the issuer.
  - A change of control or merger involving the issuer.
  - Bankruptcy or insolvency of the issuer.
  - The incurrence of transaction costs to dispose of equity securities received upon settlement of an equity-linked option.
8.4.7.6.4.1 Explicit Inputs

To evaluate whether an adjustment to the settlement amount that is based on an explicit input precludes an equity conversion feature from being considered indexed to an entity's own stock, the entity considers the questions below, assessing each explicit input separately. If, because of an adjustment that is based on an explicit input, an entity determines that the feature is not indexed to the entity's own stock, the equity conversion feature does not qualify for the scope exception in ASC 815-10-15-74(a):

1. Is the explicit input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares?

For the equity conversion feature to be considered indexed to the entity's stock, the answer must be yes. If the answer is no, the equity conversion feature does not qualify for the scope exception in ASC 815-10-15-74(a) irrespective of whether it meets the other conditions for equity classification.

If the settlement terms are adjusted in response to changes in an input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares, those adjustments do not necessarily preclude an entity from considering the feature to be indexed to the reporting entity's stock. If, however, the settlement amount varies in response to changes in explicit inputs other than those used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares (i.e., extraneous variables), the feature is not considered indexed to the reporting entity's stock.

The table below lists examples of explicit inputs that may or may not preclude equity classification if an adjustment is made to the settlement amount in response to a change in the explicit input.

<table>
<thead>
<tr>
<th>Permissible (Equity Classification Not Precluded)</th>
<th>Not Permissible (Equity Classification Precluded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The issuer's stock price (including a weighted-average price over a reasonable period; see Section 4.3.5.1 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).</td>
<td>• Revenue, net income, EBITDA, or other operating metric of the issuer (unless the formula is designed to equal or closely approximate the fair value of the entity's stock; see Section 4.3.5.6 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).</td>
</tr>
<tr>
<td>• The stock price of a consolidated subsidiary that is a substantive entity (see Section 2.6.1 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).</td>
<td>• The authorized and unissued common shares of the issuer.</td>
</tr>
<tr>
<td>• The exercise (or forward) price.</td>
<td>• The number of outstanding common shares of the issuer (unless the terms of the instrument are adjusted solely to offset the effect of a dilutive event).</td>
</tr>
<tr>
<td>• The term of the instrument.</td>
<td>• A commodity price (e.g., gold; see Section 4.3.5.5 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).</td>
</tr>
<tr>
<td>• Expected dividends (see Section 4.3.5.3 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).</td>
<td>• A foreign currency index or rate (see Section 4.3.8 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).</td>
</tr>
<tr>
<td>• Cost of borrowing the entity's stock (cost of stock borrow; see Section 4.3.5.4 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).</td>
<td>• An inflation rate.</td>
</tr>
<tr>
<td>• Risk-free interest rates (i.e., LIBOR, the federal funds rate, or the U.S. Treasury rate; see Sections 4.3.5.2, 4.3.5.9, and 4.3.5.10 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).</td>
<td>• Stock option exercise behavior (see Section 4.3.5.8 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Permissible (Equity Classification Not Precluded)</th>
<th>Not Permissible (Equity Classification Precluded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Stock price volatility (see Section 4.3.5.4A of Deloitte’s <em>A Roadmap to Accounting for Contracts on an Entity’s Own Equity</em>).</td>
<td></td>
</tr>
<tr>
<td>• The entity’s credit spread.</td>
<td></td>
</tr>
</tbody>
</table>

2. **Could a change in the explicit input (other than the reporting entity’s stock price) affect the settlement amount in a manner inconsistent with how a change in the input would affect the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares?**

For an equity conversion feature to be indexed to the entity’s stock, the answer must be no. If the answer is yes, the equity conversion feature does not qualify for the scope exception in ASC 815-10-15-74(a) irrespective of whether it meets the other conditions for equity classification.

An adjustment in response to a change in an explicit input does not necessarily need to reflect the whole effect that the variable would have had on the fair value of a fixed-for-fixed forward or option on equity shares. If, however, an equity conversion contains leverage that results in greater exposure to an input (other than the reporting entity’s stock price) than the exposure to the input in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares, the feature is considered not indexed to the entity’s own stock. Similarly, if a change in an explicit input (other than a change based solely on the reporting entity’s stock price) affects the settlement amount of the feature in a manner inconsistent with the effect that the underlying would have on the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares (e.g., the underlying affects the settlement amount inversely), the feature is considered not indexed to the entity’s own equity.

3. **Could a change in the explicit input (other than the reporting entity’s stock price) result in a settlement at a fixed monetary amount?**

For an equity conversion feature to be indexed to the entity’s stock, the answer must be no. If the answer is yes, the equity conversion feature does not qualify for the scope exception in ASC 815-10-15-74(a) irrespective of whether it meets the other conditions for equity classification. Note, however, that an equity conversion feature that settles at a fixed monetary amount generally should be evaluated as a share-settled redemption feature, not as a conversion feature (see Sections 8.2.2 and 8.4.7.2.5).
8.7.6.4.2 Implicit Inputs

An entity considers the three questions below when evaluating whether adjustments to the settlement amount that are based on an implicit input preclude the equity conversion feature from qualifying for the scope exception in ASC 815-10-15-74(a). The entity evaluates each implicit input separately. These considerations are relevant regardless of whether the implicit input (1) affects the exercise price or forward price of the equity conversion feature or the number of equity shares used to calculate the settlement amount or (2) results in an immediate settlement of the feature at an adjusted settlement amount. If, because of an adjustment that is based on an implicit input, an entity determines that the feature is not indexed to the entity’s own stock, the equity conversion feature does not qualify for the scope exception in ASC 815-10-15-74(a):

1. Does the adjustment to the settlement provisions result from the occurrence or nonoccurrence of a specified event that invalidates an implicit assumption used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares?

For an equity conversion feature to be indexed to the entity’s stock, the answer must be yes. If the answer is no, the equity conversion feature does not qualify for the scope exception in ASC 815-10-15-74(a) irrespective of whether it meets the other conditions for equity classification.

An equity conversion feature is not indexed to the entity’s stock if its terms include an adjustment in response to the occurrence or nonoccurrence of a specified event unless the occurrence or nonoccurrence of the event is inconsistent with an implicit assumption in a standard valuation model used to determine the fair value of a fixed-for-fixed forward or option on equity shares.

The table below lists examples of events in response to which adjustments to the settlement amount may or may not preclude equity classification.

<table>
<thead>
<tr>
<th>Permissible (Equity Classification Not Precluded)</th>
<th>Not Permissible (Equity Classification Precluded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Dilutive events affecting the underlying shares (e.g., a stock split, subdivision, combination, reclassification, or recapitalization; see Section 4.3.7.1 of Deloitte’s <em>A Roadmap to Accounting for Contracts on an Entity’s Own Equity</em>).</td>
<td>• Occurrence or nonoccurrence of an IPO (unless the adjustment provision meets the definition of a down-round feature; see Section 4.3.7.4 of Deloitte’s <em>A Roadmap to Accounting for Contracts on an Entity’s Own Equity</em>).</td>
</tr>
<tr>
<td>• A down-round protection feature (see Section 4.3.7.2 of Deloitte’s <em>A Roadmap to Accounting for Contracts on an Entity’s Own Equity</em>).</td>
<td>• A change in the entity’s number of authorized and unissued common shares.</td>
</tr>
<tr>
<td>• The counterparty in a gain position does not receive the full monetary value it is due upon settlement depending on the form of settlement (e.g., as a result of transaction costs related to the disposition of shares received or a discount in the value of unregistered shares; see Sections 4.3.7.6, 4.3.7.7, and 4.3.7.8 of Deloitte’s <em>A Roadmap to Accounting for Contracts on an Entity’s Own Equity</em>).</td>
<td>• A change in the number of outstanding common shares that occurs as a result of a specified event other than a dilutive event.</td>
</tr>
<tr>
<td>• The counterparty is unable to participate in any extraordinary distribution of cash or noncash consideration or other similar event in which all holders of underlying shares may participate (e.g., a tender offer made by a third party).</td>
<td>• A provision that requires shareholder approval.</td>
</tr>
<tr>
<td>• The entity’s bankruptcy or insolvency (unless the event results in a hedging disruption).</td>
<td>• The entity’s bankruptcy or insolvency (unless the event results in a hedging disruption).</td>
</tr>
<tr>
<td>• Delisting of the underlying shares (unless the event results in a hedging disruption).</td>
<td>• Delisting of the underlying shares (unless the event results in a hedging disruption).</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Permissible (Equity Classification Not Precluded)</th>
<th>Not Permissible (Equity Classification Precluded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The counterparty is not able to realize the remaining time value inherent in the contract (i.e., loss of time value upon early settlement; see Section 4.3.7.10 of Deloitte's <em>A Roadmap to Accounting for Contracts on an Entity's Own Equity</em>).</td>
<td></td>
</tr>
<tr>
<td>• The counterparty is unable to maintain a standard hedge position in the underlying shares (e.g., loss of stock borrow).</td>
<td></td>
</tr>
<tr>
<td>• The counterparty experiences a hedge disruption event because of discontinuities in the price of the underlying shares (e.g., as a result of a merger event or change in control, tender offer, termination of trading, governmental or political event, or natural disaster; see Section 4.3.7.5 of Deloitte's <em>A Roadmap to Accounting for Contracts on an Entity's Own Equity</em>).</td>
<td></td>
</tr>
</tbody>
</table>

2. *Is the adjustment to the settlement terms consistent with the effect that the occurrence or nonoccurrence of the specified event had on the fair value of the equity conversion feature (i.e., does the adjustment offset — at least partially — the net gain or loss on the equity conversion feature that occurs as a result of the specified event)?*

For an equity conversion feature to be indexed to the entity's stock, the answer must be yes. If the answer is no, the equity conversion feature does not qualify for the scope exception in ASC 815-10-15-74(a) irrespective of whether it meets the other conditions for equity classification.

An equity conversion feature is not indexed to the entity's stock if its terms include an adjustment in response to the occurrence or nonoccurrence of a specified event that is inconsistent with an implicit assumption in a standard valuation model unless the adjustment is consistent with the effect that the occurrence or nonoccurrence of the specified event has on the fair value of the instrument. Thus, adjustments to neutralize or partially offset the effects of events that invalidate an implicit assumption in a valuation model do not preclude an equity conversion feature from being indexed to the entity's stock. In this context, “neutralize” means that the calculation of the adjustment to the settlement terms of the equity conversion feature appropriately offsets the net gain or loss on the feature that occurred as a result of the specified event.

Adjustments from implicit inputs do not necessarily have to result in a complete neutralization of the effect that the occurrence or nonoccurrence of a specified event has on the fair value of the equity conversion feature (i.e., the net gain or loss on the feature that occurs as a result of the specified event). However, an adjustment to the terms of an equity conversion feature to reflect more than 100 percent of the effect that the variable has on the fair value of a fixed-for-fixed forward or option on equity shares precludes the equity conversion feature from being indexed to the entity's stock because the additional exposure is inconsistent with a fixed-for-fixed forward or option on equity shares.
Note that a contract may be considered indexed to the entity’s stock even if no adjustments are made upon the occurrence or nonoccurrence of an event that invalidates an implicit assumption. In a fixed-for-fixed forward or option on equity shares, no adjustments are made upon the occurrence of an event that is inconsistent with any of the implicit assumptions. Instead, the counterparty to the instrument is exposed to the risk of a change in the fair value of the instrument upon the occurrence or nonoccurrence of such events. Further, an equity conversion feature may be considered indexed to the entity’s stock even if an adjustment upon the occurrence or nonoccurrence of an event that invalidates an implicit assumption only partially offsets the effect of the specified event.

For an equity conversion feature to qualify as equity, an adjustment cannot compensate the counterparty for adverse changes in the entity’s share price that are not attributable to the effect of the specified event. This is because such an adjustment could “protect” the counterparty from an adverse price change that results from events other than an event that invalidates an implicit assumption. Similarly, an adjustment based on the difference between the pre-event share price and the post-event share price generally would preclude equity classification because the share price could have changed for reasons other than the event itself (ASC 815-40-55-42). The principle is that an adjustment should be designed to capture only the theoretical effect of the event that invalidates an implicit assumption (e.g., a dilutive event).

A settlement of an equity conversion feature at its fair value as of the settlement date (i.e., that reflects the effect of a specified event) is not considered to have been affected by an implicit input because no additional value is exchanged between the counterparties (i.e., no adjustment is made for the net gain or loss resulting from the invalidation of an implicit input).

3. **Could a change in an implicit input result in a settlement at a fixed monetary amount?**

For an equity conversion feature to be indexed to the entity’s stock, the answer must be no. If the answer is yes, the equity conversion feature does not qualify for the scope exception in ASC 815-10-15-74(a) irrespective of whether it meets the other conditions for equity classification.

If a change in an implicit input can result in a settlement that is based on a fixed monetary amount, the equity conversion feature is not indexed to the reporting entity’s stock. This is because the occurrence of the specified event would result in a settlement amount that would be inconsistent with the effect that the event would have had on the fair value of a fixed-for-fixed forward or option on equity shares. Note, however, that an equity conversion feature that settles at a fixed monetary amount generally should be evaluated as a share-settled redemption feature, not as a conversion feature (see Sections 8.2.2 and 8.4.7.2.5).

### Example 8-19

**Convertible Debt With a Share-Settled Redemption Feature**

An entity has issued 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 80 percent of the stock price in the IPO or $50. Although the conversion price in this scenario is reduced to the IPO price if the IPO price is below $50, the potential adjustment is not a down-round feature because the associated settlement has a monetary value equal to a fixed monetary amount ($10,000,000 ÷ 80% = $12,500,000). The entity should evaluate this share-settled redemption feature in a manner similar to how it evaluates 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 8.4.7.2.5).
Example 8-20

Convertible Debt With Down-Round Feature

An entity has issued a 10-year convertible debt instrument with a principal amount of $10 million. The conversion price is $50. If an IPO were to occur with an IPO price of less than $50, the conversion price would be 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 later. In such a scenario, the potential adjustment to the conversion price upon an IPO is a down-round feature because the conversion feature has a monetary value that varies on the basis of changes in the issuer's stock price both before and after the IPO.

Example 8-21

Convertible Debt With Make-Whole Conversion Shares

Entity A has issued convertible notes. Each note is convertible into A's common stock at the holder's election at a conversion rate of 15 shares of common stock per $1,000 principal amount of notes. The terms of the notes specify that if a change in control or sale of substantially all of A's assets occurs and the holder elects to convert, A will adjust the conversion rate by increasing the number of shares that will be delivered upon conversion. The number of additional shares, if any, that will be delivered is determined by reference to the make-whole table below on the basis of (1) the effective date on which the transaction occurs and (2) the stock price as of that date. The adjustment to the conversion rate is designed to compensate the holder for the expected option value that the holder would lose as a result of the transaction. That is, the adjustment is intended to make the holder whole for the expected loss of the time value of money that would result from an early exercise of the conversion option. Accordingly, the aggregate fair value of the shares deliverable (including the make-whole shares) upon conversion is expected to approximate the fair value of the conversion option on the settlement date as long as there has been no change in relevant pricing inputs (other than stock price and time) since the instrument's inception. In no event will the conversion rate be increased to exceed 20.36 shares of common stock per $1,000 principal amount of notes.

<table>
<thead>
<tr>
<th>Effective Date</th>
<th>$45</th>
<th>$50</th>
<th>$70</th>
<th>$90</th>
<th>$110</th>
<th>$130</th>
<th>$150</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 15, 20X1</td>
<td>5.36</td>
<td>4.56</td>
<td>1.84</td>
<td>0.74</td>
<td>0.26</td>
<td>0.05</td>
<td>0.01</td>
</tr>
<tr>
<td>March 15, 20X2</td>
<td>5.36</td>
<td>4.50</td>
<td>1.73</td>
<td>0.64</td>
<td>0.19</td>
<td>0.02</td>
<td>0.01</td>
</tr>
<tr>
<td>March 15, 20X3</td>
<td>5.36</td>
<td>4.47</td>
<td>1.52</td>
<td>0.47</td>
<td>0.10</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>March 15, 20X4</td>
<td>5.36</td>
<td>4.18</td>
<td>1.08</td>
<td>0.21</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>March 15, 20X5</td>
<td>5.36</td>
<td>3.50</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
</tbody>
</table>

In the make-whole table above, the conversion option is not precluded from being indexed to A's stock because the adjustment (1) results from the occurrence of an event that invalidates an implicit assumption used in the pricing of a fixed-for-fixed option on equity shares (i.e., that the holder will realize the remaining time value inherent in the notes), (2) is directionally consistent with compensating the holders for lost time value (i.e., the number of additional shares that will be delivered is reduced as the stock price increases and as time to maturity decreases), (3) does not protect the holder from an adverse price change that is unrelated to the event, (4) is not leveraged (i.e., does not contain compensation in excess of expected lost time value), and (5) does not result in the delivery of shares worth a fixed monetary amount.

If an entity concludes that an equity conversion feature is indexed to its own stock under ASC 815-40-15, the entity would also need to assess whether the equity classification conditions in ASC 815-40-25 are met to determine whether it can apply the scope exception in ASC 815-10-15-74(a) (see Section 8.4.7.6.5).
For a comprehensive discussion of step 2 of the indexation analysis under ASC 815-40-15, see Section 4.3 of Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity*.

### 8.4.7.6.5 Determining Whether the Feature Meets the Equity Classification Conditions in ASC 815-40-25

**ASC 815-40**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Condition</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-7</td>
<td>Contracts that include any provision that could require net cash settlement cannot be accounted for as equity of the entity (that is, asset or liability classification is required for those contracts), except in those limited circumstances in which holders of the underlying shares also would receive cash (as discussed in the following two paragraphs and paragraphs 815-40-55-2 through 55-6).</td>
</tr>
<tr>
<td>25-8</td>
<td>Generally, if an event that is not within the entity’s control could require net cash settlement, then the contract shall be classified as an asset or a liability. However, if the net cash settlement requirement can only be triggered in circumstances in which the holders of the shares underlying the contract also would receive cash, equity classification is not precluded.</td>
</tr>
<tr>
<td>25-9</td>
<td>This Subtopic does not allow for an evaluation of the likelihood that an event would trigger cash settlement (whether net cash or physical), except that if the payment of cash is only required upon the final liquidation of the entity, then that potential outcome need not be considered when applying the guidance in this Subtopic.</td>
</tr>
<tr>
<td>25-10</td>
<td>Because any contract provision that could require net cash settlement precludes accounting for a contract as equity of the entity (except for those circumstances in which the holders of the underlying shares would receive cash, as discussed in the preceding two paragraphs and paragraphs 815-40-55-2 through 55-6), all of the following conditions must be met for a contract to be classified as equity:</td>
</tr>
<tr>
<td>a.</td>
<td>Settlement permitted in unregistered shares. The contract permits the entity to settle in unregistered shares.</td>
</tr>
<tr>
<td>b.</td>
<td>Entity has sufficient authorized and unissued shares. The entity has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the derivative instrument could remain outstanding.</td>
</tr>
<tr>
<td>c.</td>
<td>Contract contains an explicit share limit. The contract contains an explicit limit on the number of shares to be delivered in a share settlement.</td>
</tr>
<tr>
<td>d.</td>
<td>No required cash payment if entity fails to timely file. There are no required cash payments to the counterparty in the event the entity fails to make timely filings with the Securities and Exchange Commission (SEC).</td>
</tr>
<tr>
<td>e.</td>
<td>No cash-settled top-off or make-whole provisions. There are no cash settled top-off or make-whole provisions.</td>
</tr>
<tr>
<td>f.</td>
<td>No counterparty rights rank higher than shareholder rights. There are no provisions in the contract that indicate that the counterparty has rights that rank higher than those of a shareholder of the stock underlying the contract.</td>
</tr>
<tr>
<td>g.</td>
<td>No collateral required. There is no requirement in the contract to post collateral at any point or for any reason.</td>
</tr>
</tbody>
</table>

Paragraphs 815-40-25-39 through 25-42 explain the application of these criteria to conventional convertible debt and other hybrid instruments.

For an equity conversion feature to qualify for the scope exception in ASC 815-10-15-74(a), the feature must require or permit the debtor to settle the feature either physically or net in shares. Any provision that could require the issuer to net cash settle the conversion feature precludes application of the own-equity scope exception with limited exceptions. The likelihood of an event that would trigger a net cash settlement does not matter.
However, a contractual term that could require the equity conversion feature to be net cash settled is permitted if:

- The event that would cause net cash settlement is within the entity’s control (see Section 5.2.3.1 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity).
- The feature is required to be net cash settled only upon the final liquidation of the entity (see Section 5.2.3.2 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity).
- The feature is required to be net cash settled only if all holders of the shares underlying the contract would also receive cash in exchange for their shares (see Section 5.2.3.3 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity), such as upon a change of control (see Section 5.2.3.4 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity) or upon nationalization or expropriation (see Section 5.2.3.5 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity).

Some convertible debt instruments give the investor a share-settled equity conversion option and a cash-settled redemption option with a redemption amount that is the greater of the fair value of the underlying shares or the face amount of the securities. In such a scenario, the “greater-of” redemption option effectively gives the security’s holder the ability to net cash settle the embedded conversion option. Accordingly, the conversion option does not qualify as equity under ASC 815-40.

Even if a contract ostensibly requires or permits an entity to settle in shares, the entity cannot assume that it has the ability to do so unless there are no circumstances in which it could be forced to net cash settle the equity conversion feature. If such circumstances exist, equity classification is generally prohibited. For an entity to conclude that it cannot be required to net cash settle a contract, the entity must ensure that the seven conditions in ASC 815-40-25-10 are met. These conditions address whether there are any circumstances under which the issuer could be forced to net cash settle the contract given the contract’s terms and the regulatory and legal framework.

The conditions in ASC 815-40-25-10 do not apply to an embedded conversion option within “conventional convertible debt.” Thus, a conversion option in such a convertible debt instrument may fail to meet one or more of those conditions and still qualify for the scope exception in ASC 815-10-15-74(a). As explained in ASC 815-40-25-39, conventional convertible debt represents an “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).” Thus, for an instrument to be considered conventional convertible debt, the issuer must have the ability to settle it gross by delivering a fixed number of shares, although the issuer might alternatively elect to settle the instrument in an equivalent amount of cash. The holder’s ability to exercise the conversion option may be “based on the passage of time or a contingent event” (ASC 815-40-25-41). For further discussion of the evaluation of conventional convertible debt, see Section 5.5 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity.

For a comprehensive discussion of the equity classification conditions in ASC 815-40-25, see Chapter 5 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity.
**8.4.7.7 Scope Exception for Certain Share-Based Payment Transactions**

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-74</strong> Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic: . . .</td>
</tr>
<tr>
<td>b. Contracts issued by the entity that are subject to Topic 718. If any such contract ceases to be subject to Topic 718 in accordance with paragraphs 718-10-35-9 through 35-14, the terms of that contract shall then be analyzed to determine whether the contract is subject to this Subtopic. An award that ceases to be subject to Topic 718 in accordance with those paragraphs shall be analyzed to determine whether it is subject to this Subtopic.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 718-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-9A</strong> 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.</td>
</tr>
</tbody>
</table>

Under ASC 718, share-based payment arrangements generally remain within the scope of ASC 718 throughout their lives, provided that they are not modified after they are issued to grantees. However, convertible debt instruments issued to nonemployees in exchange for goods or services become subject to other GAAP for financial instruments once they are fully vested. Accordingly, an equity conversion feature in such an instrument is exempt from the scope of ASC 815 until vesting occurs.

**Changing Lanes**

In ASU 2020-06, the FASB amended the guidance that currently requires convertible instruments granted to nonemployees in a share-based payment transaction to become subject to other GAAP once the award is fully vested. Under the amended 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 U.S. GAAP that applies 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). For more information about ASU 2020-06, including the transition provisions, see Deloitte’s August 5, 2020, Heads Up.

**8.4.8 Foreign Currency Features**

**8.4.8.1 Background**

This section discusses the analysis of whether a feature whose value changes on the basis of changes in one or more foreign currency exchange rates should be separated from a debt host contract and accounted for as a derivative. For example, some debt instruments contain an option to convert principal or interest payments or both at a fixed foreign currency exchange rate. Further, the terms of some debt instruments (e.g., dual currency bonds) have principal and interest payments denominated in different currencies.
This section does not apply to a feature that does not present an exposure to the risk of changes in the exchange rate of foreign currency that is different from the currency in which the debt is denominated, such as certain currency conversion convenience clauses (see Section 8.4.8.6). Further, it does not apply to debt merely by virtue of the denomination of such debt in a currency that is different from the debtor's functional currency unless the debt contains one or more features that are denominated in a currency that is different from that in which the debt was denominated (e.g., a foreign currency option).

### 8.4.8.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of a foreign currency feature embedded in a debt host contract. Further, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>Yes</td>
<td>A feature that presents an exposure to changes in the exchange rate of foreign currency that is different from the debt's currency of denomination is not clearly and closely related to a debt host.</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). However, the fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>Yes</td>
<td>A feature that presents an exposure to changes in a foreign currency exchange rate meets the definition of a derivative (see Section 8.4.8.4).</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>It depends</td>
<td>The debtor should evaluate whether the foreign currency feature is exempt from derivative accounting under ASC 815-15-15-5 (see Section 8.4.8.5).</td>
</tr>
</tbody>
</table>

As shown in the table above, a debtor's determination of whether a foreign currency feature must be bifurcated from a debt host contract and accounted for as derivative tends to focus on whether the feature meets a scope exception related to derivative accounting (see Section 8.4.8.5) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3). Typically, such features meet the definition of a derivative (see Section 8.4.8.4) and are not clearly and closely related to a debt host (see Section 8.4.8.3 below).

### 8.4.8.3 Clearly-and-Closely-Related Analysis

A feature that presents an exposure to changes in the exchange rate of foreign currency that is different from the debt's currency of denomination is not clearly and closely related to a debt host. As noted in ASC 815-15-55-212, for example, a “foreign currency option is not clearly and closely related to issuing a loan.” However, this guidance does not apply to a feature that does not present an exposure to the risk of changes in the exchange rate of foreign currency that is different from the currency in which the debt is denominated (see Section 8.4.8.6).
### 8.4.8.4 Derivative Analysis

The table below presents an analysis of whether a foreign currency feature embedded in a debt host contract meets the definition of a derivative. Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
<td>An embedded feature that presents an exposure to changes in a foreign currency exchange rate that is based on a currency that is different from the debt's currency of denomination has both an underlying (the foreign currency rate) and a notional amount (e.g., the debt's outstanding amount)</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
<td>The initial net investment in a feature that presents an exposure to changes in a foreign currency exchange rate that is based on a currency that is different from the debt's currency of denomination is its fair value (i.e., the amount that would need to be paid to acquire the feature on a stand-alone basis without the host contract). This feature has an initial net investment that is smaller than would be required for a direct investment that has the same exposure to changes in foreign currency exchange rates.</td>
</tr>
<tr>
<td>Net settlement (see Section 8.3.4.4)</td>
<td>Yes</td>
<td>A foreign currency feature meets the net settlement condition because it is net cash settled.</td>
</tr>
</tbody>
</table>

As shown in the table above, a foreign currency feature embedded in a debt host contract meets the definition of a derivative. Therefore, the analysis of whether such a feature must be bifurcated as a derivative tends to focus on whether the feature is exempt from the scope of derivative accounting (see Section 8.4.8.5) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3).

### 8.4.8.5 Exception for Certain Foreign Currency Features

**ASC 815-15**

**15-5** Unsettled foreign currency transactions, including financial instruments, shall not be considered to contain embedded foreign currency derivatives under this Subtopic if the transactions meet all of the following criteria:

- They are monetary items.
- They have their principal payments, interest payments, or both denominated in a foreign currency.
- They are subject to the requirement in Subtopic 830-20 to recognize any foreign currency transaction gain or loss in earnings.

**Case Q: Dual Currency Bond**

**55-209** A dual currency bond provides for repayment of principal in U.S. dollars and periodic interest payments denominated in a foreign currency. In this circumstance, a U.S. entity with the dollar as its functional currency is borrowing funds from an independent party with those repayment terms as described.
55-210 Because the portion of this instrument relating to the periodic interest payments denominated in a foreign currency is subject to the requirement in Topic 830 to recognize the foreign currency transaction gain or loss in earnings, the instrument should not be considered as containing an embedded foreign currency derivative instrument pursuant to paragraph 815-15-15-10. In this circumstance, the U.S. entity has the dollar as the functional currency and is making interest payments in a foreign currency. Remeasurement of the liability is required using future equivalent dollar interest payments determined by the current spot exchange rate and discounted at the historical effective interest rate.

Case R: Short-Term Loan With a Foreign Currency Option

55-211 A U.S. lender issues a loan at an above-market interest rate. The loan is made in U.S. dollars, the borrower's functional currency, and the borrower has the option to repay the loan in U.S. dollars or in a fixed amount of a specified foreign currency.

55-212 This instrument can be viewed as combining a loan at prevailing market interest rates and a foreign currency option. The lender has written a foreign currency option exposing it to changes in foreign currency exchange rates during the outstanding period of the loan. The premium for the option has been paid as part of the interest rate. Because the borrower has the option to repay the loan in U.S. dollars or in a fixed amount of a specified foreign currency, the provisions of paragraph 815-15-15-5 are not relevant to this Case. That paragraph addresses foreign-currency-denominated interest or principal payments but does not apply to foreign currency options embedded in a functional-currency-denominated debt host contract. Because a foreign currency option is not clearly and closely related to issuing a loan, the embedded option should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Subtopic. In contrast, if both the principal payment and the interest payments on the loan had been payable only in a fixed amount of a specified foreign currency, there would be no embedded foreign currency derivative pursuant to this Subtopic.

Under ASC 815-15-15-5, debt with principal or interest payments (or both) that are denominated in a foreign currency is deemed not to contain an embedded foreign currency derivative if the amounts that are denominated in a foreign currency must be remeasured at spot rates under ASC 830-20 (see Section 14.2.3). If the interest payments of a dual-currency bond whose principal is denominated in dollars are denominated in a different currency, for example, ASC 815-15-55-210 requires the interest payments to be accounted for by discounting “the future equivalent dollar interest payments determined by the current spot exchange rate” at the debt's original effective interest rate. Under the interest method, the principal payment would also be discounted by using the debt's original effective interest rate (see Section 6.2).

The exemption in ASC 815-15-15-5 does not apply to a foreign currency feature that is not required to be remeasured under ASC 830-20 for changes in spot foreign currency exchange rates. For example, the exemption does not apply to an option to pay principal or interest payments in one or more alternative currencies other than the debt's currency of denomination unless the amount owed in the alternative currency is determined by applying the current spot exchange rate at the time of payment to the amount owed in the debt's currency of denomination (see Section 8.4.8.6).

**8.4.8.6 Convenience Clauses That Do Not Present a Foreign Currency Exposure**

Sometimes, debt contracts contain a convenience clause that permits or requires principal or interest payments or both to be made in a currency that is different from that in which the debt is denominated. The amount of the payment is determined by applying the current spot foreign currency exchange rate at the time of payment to the amount owed in the debt's currency of denomination. For example, the terms of a debt instrument denominated in USD might specify that payments may be made in one or more currencies at the current spot exchange rate at the time of payment. Such a clause does not
represent a foreign currency feature that should be evaluated for bifurcation since its monetary value does not vary on the basis of a foreign currency exchange rate.

8.4.9 Payment Features Indexed to Commodities or Other Nonfinancial Items

8.4.9.1 Background

This section discusses the analysis of whether payment features that are indexed to the price or value of a commodity or other nonfinancial item (e.g., a commodity-indexed principal or interest payment or a participating mortgage feature) should be separated from a debt host contract and accounted for as derivatives under ASC 815-15.

8.4.9.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of a payment feature indexed to the price or value of a commodity or other nonfinancial item. However, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>Yes</td>
<td>The price or value of a commodity or other nonfinancial item is not clearly and closely related to a debt host.</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). However, the fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>Yes</td>
<td>Payments indexed to the price or value of a commodity or other nonfinancial item meet the definition of a derivative.</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>It depends</td>
<td>ASC 815 contains a scope exception related to certain non-exchange-traded contracts with payments that are based on the price or value of a nonfinancial item of one of the parties to the contract provided that the asset is not readily convertible to cash (see Section 8.4.9.5).</td>
</tr>
</tbody>
</table>

As shown in the table above, a debtor's determination of whether a payment feature indexed to a commodity or other nonfinancial item must be bifurcated as a derivative tends to focus on whether the feature is exempt from the scope of derivative accounting (see Section 8.4.9.5), unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3). Such a feature is not clearly and closely related to a debt host and typically meets the definition of a derivative (see Section 8.4.9.4).
8.4.9.3  Clearly-and-Closely-Related Analysis

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<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>
</tr>
</tbody>
</table>

**Case J: Crude Oil Knock-In Note**

**55-194** An illustrative crude oil knock-in note has a 1 percent coupon and guarantees repayment of principal with upside potential based on the strength of the oil market.

**55-195** A crude oil knock-in note essentially combines an interest-bearing instrument with a series of option contracts. A significant portion of the coupon interest rate is, in effect, used to purchase options that provide the investor with potential gains resulting from increases in specified crude oil prices. Because the option contracts are indexed to the price of crude oil, they are not clearly and closely related to an investment in an interest-bearing note. Therefore, the embedded option contract should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Subtopic.

**Case K: Gold-Linked Bull Note**

**55-196** An illustrative gold-linked bull note has a fixed 3 percent coupon and guarantees repayment of principal with upside potential if the price of gold increases.

**55-197** A gold-linked bull note can be viewed as combining an interest-bearing instrument with a series of option contracts. A portion of the coupon interest rate is, in effect, used to purchase call options that provide the investor with potential gains resulting from increases in gold prices. Because the option contracts are indexed to the price of gold, they are not clearly and closely related to an investment in an interest-bearing note. Therefore, the embedded option contracts should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Subtopic.

A feature that adjusts the payments of a debt contract on the basis of the price or value of a commodity or other nonfinancial item is not clearly and closely related to a debt host. This determination applies irrespective of whether the debtor owns the commodity or other nonfinancial item.

8.4.9.4  Derivative Analysis

The table below presents an analysis of whether a payment feature indexed to a commodity or other nonfinancial item meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.
Chapter 8 — Embedded Derivatives

### Characteristics of a Derivative

<table>
<thead>
<tr>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
</tr>
<tr>
<td>Net settlement (see Section 8.3.4.4)</td>
<td>Yes</td>
</tr>
</tbody>
</table>

As shown in the table above, a payment feature indexed to the price or value of a nonfinancial asset typically meets the definition of a derivative. Because such a feature is not clearly and closely related to a debt host, the debtor must assess whether it qualifies for a scope exception (see Section 8.4.9.5) unless the debtor has elected to account for the debt under the fair value option in ASC 815-15 or ASC 825-10 (see Section 8.3.3).

### 8.4.9.5 Scope Exception for Certain Nonfinancial Items of One of the Parties

**ASC 815-10**

15-59 Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following: . . .

b. The price or value of a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash. This scope exception applies only if both of the following are true:

1. The nonfinancial assets are unique.
2. The nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset. (If the contract is a call option, the scope exception applies only if that nonfinancial asset is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset above the option’s strike price.)

c. The fair value of a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash. . . .
ASC 815-10 (continued)

15-60 If a contract has more than one underlying and some, but not all, of them qualify for one of the scope exceptions in the preceding paragraph, the application of this Subtopic to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Subtopic if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for a scope exception.

Example 14: Certain Contracts That Are Not Traded on an Exchange — Nonfinancial Asset of One of the Parties to a Contract

55-142 This Example addresses the application of the scope exception in paragraph 815-10-15-59(b). Entity A enters into a non-exchange-traded forward contract to buy from Entity B 100 interchangeable (fungible) units of a nonfinancial asset that are not readily convertible to cash. The contract permits net settlement through its default provisions. Entity A already owns more than 100 units of that nonfinancial asset, but Entity B does not own any units of that nonfinancial asset.

55-143 The scope exception in paragraph 815-10-15-59(b) does not apply to the accounting for the contract for both of the following reasons:

a. The contract’s settlement is based on an underlying associated with a nonfinancial asset that is not unique (because it is based on the price or value of an interchangeable, nonfinancial unit).

b. The entity that owns the nonfinancial asset related to the underlying (that is, Entity A) is the buyer of the units and thus would benefit from the forward contract if the price or value increases.

Consequently, neither Entity A nor Entity B qualifies for the scope exception in paragraph 815-10-15-59(b).

ASC 815-10-15-59 contains a scope exception for certain non-exchange-traded contracts whose settlement is based on the price or value of a nonfinancial asset of one of the parties to the contract (i.e., property owned by the debtor) or the fair value of a nonfinancial liability of one of the parties to the contract. This scope exception is not available for underlyings associated with nonfinancial assets that are readily convertible to cash or that are not unique (e.g., fungible, interchangeable items). Original works of art or real estate would be considered unique nonfinancial assets (i.e., they do not have interchangeable units). Assets newly produced on an assembly line (have not been used) and are available from multiple sellers are not unique since a new asset is interchangeable with another new asset from the same production. However, once the manufactured asset has been used, the asset would be considered unique (e.g., a used car is considered unique).

Further, the scope exception for certain nonfinancial assets of one of the parties is only available if the nonfinancial asset is owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset. In other words, the scope exception is not available if the contract benefits the owner of the nonfinancial asset when the fair value of the nonfinancial asset increases. For example, the scope exception is not available if payments required under a debt obligation decrease when the fair value of a nonfinancial asset owned by the debtor increases (i.e., the owner of the nonfinancial asset — the debtor — benefits under the contract from an increase in the fair value of the asset because such increase results in a decrease in the payments to be made on the debt obligation).
Under an example participating mortgage, the investor receives a below-market interest rate and is entitled to participate in the appreciation in the fair value of the project that is financed by the mortgage upon sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. The mortgagor must continue to own the project over the term of the mortgage.

This instrument has a provision that entitles the investor to participate in the appreciation of the referenced real estate (the project). However, a separate contract with the same terms would be excluded by the exception in paragraph 815-10-15-59(b) because settlement is based on the value of a nonfinancial asset of one of the parties that is not readily convertible to cash. (This Subtopic does not modify the guidance in Subtopic 470-30.)

Paragraph 310-10-05-9 explains that loans granted to acquire operating properties sometimes grant the lender a right to participate in expected residual profit from the sale or refinancing of the property. An equity kicker (or expected residual profit) would typically not be separated from the host contract and accounted for as an embedded derivative because paragraph 815-15-25-1(c) exempts a hybrid contract from bifurcation if a separate instrument with the same terms as the embedded equity kicker is not a derivative instrument subject to the requirements of this Subtopic. Under paragraph 815-10-15-59(b), an embedded equity kicker would typically not be subject to the requirements of this Subtopic because the separate instrument with the same terms is not exchange traded and is indexed to nonfinancial assets that are not readily convertible to cash. Similarly, if an equity kicker is based on a share in net earnings or operating cash flows, it would also typically qualify for the scope exception in paragraph 815-10-15-59(d). If the embedded derivative does not need to be accounted for separately under this Subtopic, the Acquisition, Development, and Construction Arrangements Subsections of Subtopic 310-10 shall be applied.

An example of a feature for which the scope exception in ASC 815-10-15-59 would typically be available is the participation feature in a participating mortgage, which would instead be accounted for under ASC 470-30 (see Section 7.3).

8.4.10 Revenue-Based Payments

8.4.10.1 Background

This section discusses payment features that are based on specified volumes of sales or service revenues. For example, some debt instruments require payments that are indexed to revenues from the sale of goods or services or from royalty income.
8.4.10.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of a payment feature indexed to specified volumes of sales or service revenues of one of the parties to the contract. However, an entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>Yes</td>
<td>Payments that are based on specified volumes of sales or service revenues are not clearly and closely related to a debt host (see Section 8.4.10.3 below).</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). However, the fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>Yes</td>
<td>Payment features that are based on specified volumes of sales or service revenues meet the definition of a derivative.</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>It depends</td>
<td>ASC 815 contains a scope exception for non-exchange-traded contracts with payments based on specified volumes of sales or service revenues of one of the parties to the contract (see Section 8.4.10.5).</td>
</tr>
</tbody>
</table>

As shown in the table above, a debtor should evaluate whether a revenue-based payment feature is exempt from the scope of derivative accounting (see Section 8.4.10.5) since such features are not clearly and closely related to a debt host and meet the definition of a derivative.

8.4.10.3 Clearly-and-Closely-Related Analysis

Although ASC 815-15 does not specifically address whether a revenue-based payment feature is clearly and closely related to a debt host, the economic characteristics and risks of a payment feature indexed to specified volumes or sales or service revenues would not be considered clearly and closely related to the economic characteristics and risks of a debt instrument (i.e., interest rates, credit risk, and inflation rates). Note that for this purpose, a revenue-based feature does not include an underlying indexed to interest rates.
### 8.4.10.4 Derivative Analysis

The table below presents an analysis of whether a payment feature indexed to specified volumes of sales or service revenues meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
<td>A feature that could adjust the payments of a debt host contract on the basis of specified volumes of sales or service revenues has both an underlying (specified volumes of sales or service revenues) and a notional amount (e.g., the debt's outstanding amount) or payment provision.</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
<td>The initial net investment in an embedded feature is its fair value (i.e., the amount that would need to be paid to acquire the feature on a stand-alone basis without the host contract). Generally, a feature that adjusts the payments of a debt host contract on the basis of specified volumes of sales or service revenues has an initial net investment that is smaller than would be required for a direct investment that has the same exposure to changes in the value of the specified volumes of sales or service revenues (since the investment in the debt host contract does not form part of the initial net investment for the embedded feature).</td>
</tr>
<tr>
<td>Net settlement (see Section 8.3.4.4)</td>
<td>Yes</td>
<td>Adjustments to the payments of a debt host contract on the basis of specified volumes of sales or service revenues meet the net settlement condition because the feature is cash settled (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 feature's notional amount).</td>
</tr>
</tbody>
</table>

As shown in the table above, a payment feature indexed to specified volumes of sales or service revenues typically meets the definition of a derivative. However, such a feature often qualifies for a scope exception (see Section 8.4.10.5).
8.4.10.5 **Scope Exception for Certain Revenue-Based Payments**

### ASC 815-10

**15-59** Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following: . . .

- Specified volumes of sales or service revenues of one of the parties to the contract. (This scope exception applies to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. This scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices.)

**15-60** If a contract has more than one underlying and some, but not all, of them qualify for one of the scope exceptions in the preceding paragraph, the application of this Subtopic to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Subtopic if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for a scope exception.

ASC 815-10-15-59(d) provides a scope exception for derivatives in which the underlying is based on specified volumes of sales or service revenues of one of the parties to the contract. This scope exception in many circumstances may be applied to contracts for which the underlying is a broad performance measure of one of the parties to the contract (e.g., net earnings, EBITDA, or operating cash flows). Discussions with the FASB staff have indicated that the application of this scope exception is limited by the wording of ASC 815-10-15-59(d), which states, in part:

This scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices.

Accordingly, if the performance measure is based primarily or wholly on the volume of items sold or services rendered of one of the parties to the contract, then an embedded feature whose underlying is based on that performance measure potentially could qualify for the ASC 815-10-15-59(d) scope exception. However, the scope exception is not available if changes in the performance measure are highly correlated with changes in the market price of an asset or liability (e.g., changes in the market price of investments held or goods sold).

### Example 8-22

#### Debt That Contains Interest Payments Indexed to EBITDA

Company H has issued debt that includes an additional interest payment based on an increase in H's EBITDA that exceeds a specified threshold. Thus, increases in EBITDA above the threshold increase the amount of additional interest payments required. Company H determined that EBITDA is not an interest-rate index but an earnings measure that is not clearly and closely related to the debt host. Company H evaluates whether the additional interest payment feature that is based on EBITDA is an embedded derivative that must be accounted for separately.

It would be appropriate for H to apply the scope exception in ASC 815-10-15-59(d) as long as the changes in EBITDA are not primarily driven by market price changes. A contingent interest feature based on EBITDA would not qualify for the ASC 815-10-15-59(d) scope exception if changes in EBITDA are highly correlated with changes in the market price of an asset or liability (e.g., changes in the market price of investments held or goods sold).
Example 8-23

Debt With a Profit Participation Feature

A small business investment company (SBIC) issues mandatorily redeemable participating securities. The securities pay a return in the form of (1) a fixed coupon rate plus (2) a profit participation rate. The profit participation feature requires the SBIC to pay the security holders a percentage of the SBIC's earnings on certain investments held. The investments' earnings are based primarily on appreciation and returns generated from changes in the value of the underlying assets. In this example, the SBIC's investment earnings are primarily driven by market price changes. In addition, the profit participation feature only applies to certain SBIC investments rather than to total company earnings, which would not constitute a "broad performance measure" of one of the parties to the contract. Therefore, the SBIC could not apply the ASC 815-10-15-59(d) scope exception.

8.4.11 Other Payment Provisions

8.4.11.1 Background

Debt instruments often contain provisions under which payments are (1) made upon the occurrence or nonoccurrence of a specified event (e.g., the debtor is late in filing financial statements) or (2) indexed to a variable (e.g., the creditor's costs associated with a specified event) for which the accounting is not specifically addressed in ASC 815. For example, the debtor may be required to:

- Pay additional interest if the debt is not freely tradable by its holders by a specified date after issuance (e.g., the debtor must pay 0.25 percent of additional interest if the debt is not freely tradable six months after issuance).
- Pay additional interest if it has not timely filed any report or document that must be filed with the SEC (e.g., 0.25 percent of additional interest).
- Reimburse the creditor for increased costs as result of a specified event (e.g., a change in law or hedge disruption event).
- Reimburse the creditor for taxes on interest payments.

Because payment provisions that are contingent on filing with the SEC on time or on the ability to freely trade the debt 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 (see Section 3.3.3.2).

Example 8-24

Debt That Requires Additional Interest to Be Paid Upon the Occurrence of Certain Events

The terms of a debt contract require the issuer to pay additional interest at a rate equal to 0.50 percent per annum of the principal amount outstanding for each day during which (1) the debtor has failed to file any document or report that the debtor is required to file with the SEC under Section 13 or 15(d) of the Securities Exchange Act of 1934 or (2) the debt is not otherwise freely tradable (e.g., eligible for sale and transfer under SEC Rule 144) as a result of restrictions in U.S. securities laws (e.g., a registration requirement under the Securities Act of 1933) or the terms of the debt indenture.
Example 8-25

**Debt That Requires Additional Interest to Be Paid if Resale Is Restricted**

A debt instrument was issued in accordance with an exemption from registration under the Securities Act of 1933. The terms of a debt contract require the issuer to pay additional interest at a rate equal to 0.50 percent per annum if, or for as long as, a restrictive legend on the debt has not been removed, the debt is assigned a restricted CUSIP number, or the debt is not otherwise freely tradable.

### 8.4.11.2 Bifurcation Analysis

The table below presents an overview of the bifurcation analysis of a payment provision that is contingent on the occurrence or nonoccurrence of a specified event (e.g., late filings) or is indexed to a variable (e.g., the creditor’s costs associated with a specified event) for which the accounting is not specifically addressed in ASC 815.

<table>
<thead>
<tr>
<th>Bifurcation Condition</th>
<th>Condition Met?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clearly and closely related (see Section 8.3.2)</td>
<td>Yes</td>
<td>Payments that are contingent on, or indexed to, an underlying other than interest rates, the debtor’s creditworthiness, or inflation are considered not clearly and closely related to a debt host.</td>
</tr>
<tr>
<td>Hybrid instrument not measured at fair value on a recurring basis (see Section 8.3.3)</td>
<td>It depends</td>
<td>Debt is not measured at fair value on a recurring basis unless the issuer elects the fair value option in ASC 815-15 or ASC 825-10 (see Sections 4.4 and 8.5.6). However, the fair value option cannot be elected for debt that contains a separately recognized equity component at inception.</td>
</tr>
<tr>
<td>Meets the definition of a derivative (see Section 8.3.4)</td>
<td>Yes</td>
<td>Generally, a feature that adjusts the payments on a debt host contract meets the definition of a derivative (see Section 8.4.11.4).</td>
</tr>
<tr>
<td>Meets a scope exception (see Section 8.3.5)</td>
<td>Generally, no</td>
<td>Although the debtor should evaluate whether any specific scope exception is available (see Section 8.3.5), often a scope exception is not available.</td>
</tr>
</tbody>
</table>

### 8.4.11.3 Clearly-and-Closely-Related Analysis

If an embedded feature is not addressed in ASC 815, an entity must apply judgment and consider the purpose of the clearly-and-closely-related criterion (e.g., whether the feature bears a close economic relationship to the host contract or is dissimilar) and analogous guidance for other types of features. Paragraphs 305 and 306 of the Basis for Conclusions of FASB Statement 133 state, in part:

> The . . . criterion [that the economic characteristics of the derivative and the host contract are not clearly and closely related to one another] focuses on whether an embedded derivative bears a close economic relationship to the host contract. . . . Applying the approach will require judgment, which may lead to different accounting for similar instruments. To reduce that possibility, (ASC 815) provides examples illustrating how to apply the approach.

In practice, payments that are contingent on, or indexed to, an underlying other than interest rates (see Section 8.4.1), the debtor’s creditworthiness (see Section 8.4.2), or inflation (see Section 8.4.3) are considered not clearly and closely related to a debt host.
### 8.4.11.4 Derivative Analysis

The table below presents an analysis of whether a payment provision that is contingent on the occurrence or nonoccurrence of a specified event (e.g., late filings) or is indexed to a variable (e.g., the creditor’s costs associated with a specified event) for which the accounting is not specifically addressed in ASC 815 meets the definition of a derivative (see Section 8.3.4). Note, however, that an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

<table>
<thead>
<tr>
<th>Characteristics of a Derivative</th>
<th>Characteristic Present?</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying and notional amount or payment provision (see Section 8.3.4.2)</td>
<td>Yes</td>
<td>A feature that could adjust the payments of a debt host contract on the basis of a specified event or variable has both an underlying (the specified event or variable) and a notional amount (e.g., the debt’s outstanding amount) or payment provision.</td>
</tr>
<tr>
<td>Initial net investment (see Section 8.3.4.3)</td>
<td>Yes</td>
<td>The initial net investment in an embedded feature is its fair value (i.e., the amount that would need to be paid to acquire the feature on a stand-alone basis without the host contract). Generally, a feature that adjusts the payments of a debt host contract has an initial net investment that is smaller than would be required for a direct investment that has the same exposure to changes in the value of the specified event or variable (since the investment in the debt host contract does not form part of the initial net investment for the embedded feature).</td>
</tr>
<tr>
<td>Net settlement (see Section 8.3.4.4)</td>
<td>Yes</td>
<td>Adjustments to the payments of a debt host contract on the basis of a specified event or variable meets the net settlement condition because the feature is cash settled (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 feature’s notional amount).</td>
</tr>
</tbody>
</table>

As shown in the table above, a payment feature that is contingent on a specified event or indexed to a specified variable typically meets the definition of a derivative.

### 8.4.11.5 Additional Considerations

An entity should always consider the terms and conditions of a specific feature in light of all the relevant accounting guidance before reaching a conclusion about a payment provision. By analogy to ASC 815-40-25-31, an entity is not required to recognize a derivative related to normal contractual remedies for a breach of contract that the entity can prevent from occurring. For example, an entity is not required to separate an indemnification clause that holds each party harmless against damages, losses, or claims resulting from the breach of contract or gross negligence.
The entity should also consider the appropriate level of aggregation in identifying and evaluating embedded features (see Section 8.2). The terms of a debt contract might contain a cap on the total amount of additional interest that would be paid under additional interest provisions. For example, the debt terms might specify that in no event will additional interest be paid at a rate in excess of 0.50 percent regardless of the number of events or circumstances giving rise to the requirement to pay such additional interest. This means that the total amount of additional interest that might have to be paid on the debt is not necessarily simply the sum of the additional interest that might need to be paid under each of the provisions that triggers such additional interest payments. For instance, if one or more additional interest features have been triggered such that the total amount of additional interest payable is equal to the cap, there would be no incremental amount payable if another such feature is triggered. In this circumstance, the potential payoff of each additional interest provision and the payoffs under the other provisions to which the cap applies are interdependent. Under the payoff profile approach for identifying embedded features (see Sections 8.2.2 and 8.2.3), it is appropriate to evaluate such additional interest features as one combined embedded feature rather than as separate embedded features for each of the triggers. As a consequence, an additional interest feature that would have been considered clearly and closely related to a debt host if it had been evaluated on a stand-alone basis (e.g., an additional interest feature triggered by a change in the issuer’s creditworthiness; see Section 8.4.2) might have to be combined with other additional interest features that are not considered clearly and closely related to a debt host in the evaluation of whether the combined feature is clearly and closely related to the debt host.

8.4.12 Other Considerations

8.4.12.1 Background

This section addresses considerations applicable to:

- Registration payment arrangements (see Section 8.4.12.2 below).
- Payments based on climatic, geological, or other physical variables (see Section 8.4.12.3).
- Payments based on disaster experience (see Section 8.4.12.4).

8.4.12.2 Registration Payment Arrangements

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-82</strong> Registration payment arrangements within the scope of Subtopic 825-20 are not subject to the requirements of this Subtopic. The exception in this paragraph applies to both the issuer that accounts for the arrangement pursuant to that Subtopic and the counterparty.</td>
</tr>
</tbody>
</table>

A registration payment arrangement within the scope of ASC 825-20 should not be evaluated under ASC 815 even if it is embedded in a debt host contract. Instead, it is accounted for as a separate unit of account under ASC 825-20 (see Section 3.3.3.2).
8.4.12.3 Payments Based on Climatic, Geological, or Other Physical Variables

ASC 815-10

15-59 Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following:
   a. A climatic or geological variable or other physical variable. Climatic, geological, and other physical variables include things like the number of inches of rainfall or snow in a particular area and the severity of an earthquake as measured by the Richter scale. (See Example 13 [paragraph 815-10-55-135].) . . .

15-60 If a contract has more than one underlying and some, but not all, of them qualify for one of the scope exceptions in the preceding paragraph, the application of this Subtopic to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Subtopic if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for a scope exception.

ASC 815-10-15-59(a) includes a scope exception for non-exchange-traded contracts whose settlement is based on a climatic, geological, or other physical variable. Examples of payment features that may qualify for this exception include those based on measures of rainfall, snow, wind velocity, floodwater, or the severity of an earthquake or the occurrence of a hurricane. However, this scope exception is not available if the payment feature is also indexed to a financial variable, such as the dollar amount of hurricane losses (see ASC 815-10-55-137). Nevertheless, such a feature may be exempt from ASC 815 under the scope exception in ASC 815-10-15-52 through 15-57 for insurance contracts if “it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk” (e.g., a decline in revenue as a result of a hurricane event). ASC 815-10-55-135 through 55-141 provide three examples of contracts that illustrate how to distinguish between physical and financial variables.

8.4.12.4 Payments Indexed to Disaster Experience

ASC 815-15

Case O: Disaster Bond

55-204 A disaster bond pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs.

55-205 A disaster bond can be viewed as a fixed-rate bond combined with a conditional exchange contract (an option contract). The investor receives an additional coupon interest payment in return for giving the issuer an option indexed to industry loss experience on a specified disaster. Because the option contract is indexed to the specified disaster experience, it cannot be viewed as being clearly and closely related to an investment in a fixed-rate bond. Therefore, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Subtopic.

55-206 However, if the embedded derivative entitles the holder of the option (that is, the issuer of the disaster bond) to be compensated only for changes in the value of specified assets or liabilities for which the holder is at risk (including the liability for insurance claims payable due to the specified disaster) as a result of an identified insurable event (see paragraphs 815-10-15-53 through 15-54), a separate instrument with the same terms as the embedded derivative would not meet the definition of a derivative instrument in Section 815-10-15. In that circumstance, because the criterion in paragraph 815-15-25-1(c) would not be met, there is no embedded derivative to be separated from the host contract, and the disaster bond would not be subject to the requirements of this Subtopic. The investor is essentially providing a form of insurance or reinsurance coverage to the issuer.
Sometimes, the terms of a debt instrument specify that the debtor's obligation to pay the amount outstanding is extinguished if a specified disaster experience occurs. Although a payment feature that is indexed to disaster experience is not clearly and closely related to a host debt contract, such a feature may be exempt from ASC 815 under the scope exception in ASC 815-10-15-52 through 15-57 for insurance contracts if “it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.”

8.5 Accounting for Embedded Derivatives

8.5.1 Background

This section discusses the guidance that a debtor applies when it has determined that an embedded feature must be separated from its host contract and accounted for as a derivative under ASC 815. It addresses:

- Initial recognition, including the identification of the terms of the debt host contract and the embedded derivative (see Section 8.5.2 below).
- Measurement, including the allocation of debt proceeds between the host debt contract and the embedded derivative, and subsequent measurement (see Section 8.5.3).
- Embedded derivative reassessment requirements (see Section 8.5.4).
- The accounting that applies if an entity is unable to reliably identify and measure an embedded feature that must be accounted for as a derivative (see Section 8.5.5).
- The fair value election for hybrid financial instruments (see Section 8.5.6).

8.5.2 Initial Recognition

8.5.2.1 General

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-1 An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts.</td>
</tr>
</tbody>
</table>

If a separated embedded derivative represents a non-option feature (e.g., an embedded forward or swap), its terms are identified in a manner that results in a fair value of zero for the derivative at initial recognition (see Section 8.5.2.2). An option-based derivative is separated on the basis of the stated terms of the hybrid instrument, which usually results in the attribution of an initial fair value other than zero to the embedded derivative (see Section 8.5.2.3). If a host contract contains multiple embedded features that require bifurcation, they are separated as one compound embedded derivative (see Section 8.5.2.4). An entity cannot impute terms that are not clearly present in the hybrid instrument (see Section 8.3.2.4).
8.5.2.2 Identification of the Terms of a Non-Option Embedded Derivative

ASC 815-15

30-4 In separating a non-option embedded derivative from the host contract under paragraph 815-15-25-1, the terms of that non-option embedded derivative shall be determined in a manner that results in its fair value generally being equal to zero at the inception of the hybrid instrument. Because a loan and an embedded derivative can be bundled in a structured note that could have almost an infinite variety of stated terms, it is inappropriate to necessarily attribute significance to every one of the note’s stated terms in determining the terms of the non-option embedded derivative. If a non-option embedded derivative has stated terms that are off-market at inception, that amount shall be quantified and allocated to the host contract because it effectively represents a borrowing. (This paragraph does not address the bifurcation of the embedded derivative by a holder who has acquired the hybrid instrument from a third party after the inception of that hybrid instrument.) The non-option embedded derivative shall contain a notional amount and an underlying consistent with the terms of the hybrid instrument. Artificial terms shall not be created to introduce leverage, asymmetry, or some other risk exposure not already present in the hybrid instrument. Generally, the appropriate terms for the non-option embedded derivative will be readily apparent. Often, simply adjusting the referenced forward price (pursuant to documented legal terms) to be at the market for the purpose of separately accounting for the embedded derivative will result in that non-option embedded derivative having a fair value of zero at inception of the hybrid instrument.

Example 12: Separating a Non-Option Embedded Derivative

55-160 This Example illustrates the application of paragraph 815-15-30-4 and assumes that the illustrative non-option embedded derivative is a plain-vanilla forward contract with symmetrical risk exposure and that the hybrid instrument was newly entered into by the parties to the contract. Assume that the hybrid instrument is not a derivative instrument in its entirety.

55-161 Entity A plans to advance Entity X $900 for 1 year at a 6 percent interest rate and concurrently enter into an equity-based derivative instrument in which it will receive any increase or pay any decrease in the current market price ($200) of XYZ Corporation’s common stock. Those two transactions (that is, the loan and the derivative instrument) can be bundled in a structured note that could have almost an infinite variety of terms. The following presents 5 possible contractual terms for the structured note that would be purchased by Entity A for $900:

a. Note 1: Entity A is entitled to receive at the end of 1 year $954 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation’s common stock over (or under) $200.

b. Note 2: Entity A is entitled to receive at the end of 1 year $955 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation’s common stock over (or under) $201.

c. Note 3: Entity A is entitled to receive at the end of 1 year $755 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation’s common stock over (or under) $1.

d. Note 4: Entity A is entitled to receive at the end of 1 year $1,054 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation’s common stock over (or under) $300.

e. Note 5: Entity A is entitled to receive at the end of 1 year $1,060 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation’s common stock over (or under) $306.

55-162 All of these five terms of a structured note will provide the same cash flows, given a specified market price of XYZ Corporation’s common stock. If the market price of XYZ Corporation’s common stock at the end of 1 year is still $200, Entity A will receive $954 under all 5 note terms. If the market price of XYZ Corporation’s common stock at the end of 1 year increases to $306, Entity A will receive $1,060 under all 5 note terms.

55-163 For simplicity in constructing this Example, it is assumed that an equity-based cash-settled forward contract with a strike price equal to the stock’s current market price has a zero fair value. In many circumstances, a zero-value forward contract can have a strike price greater or less than the stock’s current market price.
An embedded derivative that does not involve any optionality (i.e., an embedded forward or swap) is separated from the debt host contract in a manner such that its fair is zero when the debt is first recognized (i.e., it is assumed that the entity received or paid no amount for the embedded feature). All of the proceeds of the hybrid debt instrument are allocated to the debt host contract; none are allocated to the embedded derivative upon initial recognition of the hybrid debt instrument (see Section 8.5.3.1).

Accordingly, the debtor cannot necessarily rely on the stated terms of the embedded feature for separation purposes. If the stated terms imply that the embedded feature would have some fair value at inception, those terms are redefined and calibrated so that the embedded feature instead has zero fair value at inception. For example, a stated forward price might need to be increased or decreased for separation purposes with an equal and offsetting adjustment to the manner in which the terms of the host contract are identified. The purpose of this requirement is to ensure that a debt component in a hybrid financial instrument is not attributed to an embedded derivative. If a non-option embedded derivative were to be separated on terms that result in an initial fair value other than zero (i.e., on “off-market” terms), the amount attributed to the embedded derivative effectively represents a debt element since the off-market element is “repaid” at maturity.

### 8.5.2.3 Identification of the Terms of an Option-Based Embedded Derivative

The terms of an option-based embedded derivative shall not be adjusted to result in the embedded derivative being at the money at the inception of the hybrid instrument. In separating an option-based embedded derivative from the host contract under paragraph 815-15-25-1, the strike price of the embedded derivative shall be based on the stated terms documented in the hybrid instrument. As a result, the option-based embedded derivative at inception may have a strike price that does not equal the market price of the asset associated with the underlying. The guidance in this paragraph addresses both of the following:

a. The bifurcation of the option-based embedded derivative by a holder who has acquired the hybrid instrument from a third party either at inception or after inception of that hybrid instrument

b. The bifurcation of the option-based embedded derivative by the issuer when separate accounting for that embedded derivative is required.
An embedded derivative that involves optionality is separated on the basis of the stated terms of the hybrid instrument (e.g., the strike price specified in the hybrid instrument). Under ASC 815-15-30-6, an entity is not permitted to identify terms of an option-based embedded derivative that are different from those in the hybrid instrument. For example, an entity cannot adjust the manner in which the option is identified so as to achieve an intrinsic option value of zero at inception. Economically, an embedded derivative that involves optionality is different from a non-option embedded derivative because it is possible that that the option will never be exercised. Therefore, the intrinsic value of an option-based derivative does not represent a debt element.

8.5.2.4 Multiple Embedded Derivative Features

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-7 If a hybrid instrument contains more than one embedded derivative feature that would individually warrant separate accounting as a derivative instrument under paragraph 815-15-25-1, those embedded derivative features shall be bundled together as a single, compound embedded derivative that shall then be bifurcated and accounted for separately from the host contract under this Subtopic unless a fair value election is made pursuant to paragraph 815-15-25-4.</td>
</tr>
<tr>
<td>25-8 An entity shall not separate a compound embedded derivative into components representing different risks (for example, based on the risks discussed in paragraphs 815-20-25-12[f] and 815-20-25-15[i]) and then account for those components separately.</td>
</tr>
<tr>
<td>25-9 If a compound embedded derivative comprises multiple embedded derivative features that all involve the same risk exposure (for example, the risk of changes in market interest rates, the creditworthiness of the obligor, or foreign currency exchange rates), but those embedded derivative features differ from one another by including or excluding optionality or by including a different optionality exposure, an entity shall not separate that compound embedded derivative into components that would be accounted for separately.</td>
</tr>
<tr>
<td>25-10 If some of the embedded derivative features in a hybrid instrument are clearly and closely related to the economic characteristics and risks of the host contract, those embedded derivative features shall not be included in the compound embedded derivative that is bifurcated from the host contract and separately accounted for.</td>
</tr>
</tbody>
</table>

If a hybrid contract contains more than one embedded feature that requires bifurcation under ASC 815-15-25-1, those embedded derivatives must be bundled together as a single compound embedded derivative. For example, an entity cannot separate multiple embedded derivatives and designate only some as hedging instruments. The compound embedded derivative that is separated should not include embedded features that are evaluated separately (see Section 8.2.3) and do not qualify for separation (e.g., features that are considered clearly and closely related to the debt host).

8.5.3 Measurement

8.5.3.1 Initial Measurement (Including Allocation)

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-1 All derivative instruments shall be measured initially at fair value.</td>
</tr>
</tbody>
</table>
**ASC 815-15**

**30-2** The allocation method that records the embedded derivative at fair value and determines the initial carrying value assigned to the host contract as the difference between the basis of the hybrid instrument and the fair value of the embedded derivative shall be used to determine the carrying values of the host contract component and the embedded derivative component of a hybrid instrument if separate accounting for the embedded derivative is required by this Subtopic. (Note that Section 815-15-25 allows for a fair value election for hybrid financial instruments that otherwise would require bifurcation.)

**30-3** The objective is to estimate the fair value of the derivative features separately from the fair value of the nonderivative portions of the contract. Estimates of fair value shall reflect all relevant features of each component. For example, an embedded purchased option that expires if the contract in which it is embedded is prepaid would have a different value than an option whose term is a specified period that is not subject to truncation.

An entity is required to use a “with-and-without” method (see Section 3.4.2.2) to allocate the cost basis between a bifurcated derivative and the host contract. Under this method, the entity allocates (1) a portion of the basis of the hybrid instrument (e.g., debt proceeds allocable to a hybrid debt instrument; see Section 3.4) equal to the fair value of the derivative component and then (2) the remaining carrying amount of the hybrid instrument to the host contract. Application of this method will not result in recognition of an immediate gain or loss in earnings related to the derivative because the initial carrying amount of the derivative will be its fair value.

**Example 8-26**

**Initial Recognition of Embedded Derivative**

Company ABC issues $100 million of 10-year, 4 percent fixed-rate convertible debt in $1,000 denominations. Each $1,000 bond is convertible into 20 common shares of ABC stock. Assume that the conversion option meets the definition of a derivative instrument and must be bifurcated and accounted for separately. At issuance, the fair value of the conversion option is $100 per $1,000 bond or $10 million in aggregate. The issuer would initially recognize the conversion option liability at $10 million and the host debt instrument at $90 million.

At the 2014 AICPA Conference on Current SEC and PCAOB Developments, staff from the SEC's OCA discussed situations in which entities enter into financing arrangements in which the total net proceeds received for an issued hybrid instrument are less than the fair value of the related financial liabilities that must be measured at fair value (see Section 3.4.3.1). These scenarios can occur if an entity wishes to align itself with a strategic investor or needs financing because of financial difficulties. For example, an entity that wants to align itself with a specific investor may issue $15 million of convertible debt at par and be required to bifurcate an in-the-money conversion option with a fair value of $20 million.
When a reporting entity issues a hybrid instrument and must recognize related financial liabilities (e.g., an embedded derivative that must be bifurcated) at fair values that exceed the total net proceeds received, the entity should perform a detailed analysis of the financing transaction. Its analysis should include:

- Verifying that the financial liabilities that must be measured at fair value are appropriately valued under ASC 820.
- Determining whether the transaction was conducted at arm’s length and whether the parties involved are related parties under ASC 850.
- Evaluating all elements of the transaction to determine whether there are any other rights or privileges received that should be recognized as an asset under other applicable guidance.

If, after performing this analysis, the entity concludes that the amount of financial liabilities measured at fair value still exceeds the total net proceeds received, it should recognize the excess as a loss in earnings. In addition, the entity should disclose the nature of the transaction in the financial statement footnotes, including (1) the reasons why the entity entered into the transaction and (2) the benefits received. If, however, the entity determines that the transaction was not conducted at arm’s length or was executed with a related party, it should consider consulting with the SEC staff or the entity’s accounting advisers before reaching a conclusion about the appropriate accounting treatment.

### 8.5.3.2 Subsequent Measurement

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-1 All derivative instruments shall be measured subsequently at fair value.</td>
</tr>
</tbody>
</table>

When a debtor is required to bifurcate an embedded derivative from a debt instrument, it accounts for the debt host contract under the requirements that apply to such contracts; that is, typically under the interest method in ASC 835-30 (see Section 6.2). The accounting for the debt host contract is based on the contractual cash flows that remain after separation of the cash flows attributable to the embedded derivative. For example, the application of the interest method to the debt host contract depends on the amount of proceeds and subsequent contractual cash flows that are attributed to the debt host contract. The embedded derivative is accounted for at fair value, with changes in fair value recognized in earnings (unless it is designated as a hedging instrument in a qualifying cash flow hedge or net investment hedge under ASC 815, in which case fair value changes are recognized in OCI).

### 8.5.4 Reassessment

#### 8.5.4.1 General

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-2 If a contract that did not meet the definition of a derivative instrument at acquisition by the entity meets the definition of a derivative instrument after acquisition by the entity, the contract shall be recognized immediately as either an asset or liability with the offsetting entry recorded in earnings.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-3 If a contract ceases to be a derivative instrument pursuant to this Subtopic and an asset or liability had been recorded for that contract, the carrying amount of that contract becomes its cost basis and the entity shall apply other generally accepted accounting principles (GAAP) that are applicable to that contract prospectively from the date that the contract ceased to be a derivative instrument. If the derivative instrument had been designated in a cash flow hedging relationship and a gain or loss is recorded in accumulated other comprehensive income, then the guidance in Sections 815-30-35 and 815-30-40 shall be applied accordingly.</td>
</tr>
</tbody>
</table>
ASC 815-10 (continued)

30-3 A contract recognized under paragraph 815-10-25-2 because it meets the definition of a derivative instrument after acquisition by an entity shall be measured initially at its then-current fair value.

A debtor should continually reassess whether an embedded feature meets the definition of a derivative. In particular, an entity is required to reassess whether the net settlement characteristic in the definition of a derivative is met (see Section 8.3.4.4.5). If an embedded feature begins or ceases to meet the definition of a derivative, the analysis of whether the feature should be separated and accounted for as a derivative under ASC 815 is affected.

If separation of an embedded derivative is required after the initial recognition of a debt instrument, the feature is bifurcated and recognized at fair value at the time it begins to meet the bifurcation criteria (see Section 8.3). Except for certain equity conversion features (see below), a portion of the current carrying amount of the debt instrument equal to the current fair value of the feature as of the reclassification date is reallocated to the embedded derivative in a manner consistent with the allocation guidance in ASC 815-15-30-2 (see Section 8.5.3.1).

Conversely, if separation of an embedded feature is no longer required after the initial recognition of a debt instrument, the embedded derivative is recombined with its host contract at its current fair value at the time it ceases to meet the bifurcation criteria. However, special guidance applies to bifurcated equity conversion features (see below).

8.5.4.2 Separately Recognized Conversion Feature Ceases to Qualify as Equity

ASC 470-20

35-18 A reclassification of the equity component (conversion option) would not affect the accounting for the liability component.

35-19 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.

If an equity conversion feature embedded in a debt host contract begins to meet the bifurcation criteria in ASC 815-15 after issuance and an amount attributable to the equity conversion feature was previously allocated to equity under the CCF guidance in ASC 470-20 (see Section 7.6.4.5), that amount is reclassified as an embedded derivative, and the difference between that amount and the fair value of the conversion option as of the date of reclassification is accounted for as an adjustment to equity.

If an equity conversion feature embedded in a debt host contract begins to meet the bifurcation criteria in ASC 815-15 after issuance and an amount attributable to a BCF was previously allocated to equity under the BCF guidance in ASC 470-20 (see Section 7.6.5.6), the issuer should recognize a derivative liability for the conversion feature at its fair value as of the date it ceases to meet the equity classification conditions. Further, the issuer should account for the reacquisition of the BCF on the basis of the amount that was allocated to the BCF when the debt was first issued (i.e., the entire balance of the previously recorded APIC for the BCF is eliminated). A similar approach would be applied if the convertible instrument had a separately recognized equity component for a reason other than a CCF or BCF.
8.5.4.3 Conversion Feature Ceases to Be Bifurcated as a Derivative

**ASC 815-15**

35-4 If an embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in this Subtopic, an issuer shall account for the previously bifurcated conversion option by reclassifying the carrying amount of the liability for the conversion option (that is, its fair value on the date of reclassification) to shareholders' equity. Any debt discount recognized when the conversion option was bifurcated from the convertible debt instrument shall continue to be amortized.

40-1 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.

40-4 If a convertible debt instrument with a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to the guidance in paragraph 815-15-35-4 is extinguished for cash (or other assets) before its stated maturity date, the entity shall do both of the following:

a. The portion of the reacquisition price equal to the fair value of the conversion option at the date of the extinguishment shall be allocated to equity.

b. The remaining reacquisition price shall be allocated to the extinguishment of the debt to determine the amount of gain or loss.

50-3 An issuer shall disclose both of the following for the period in which an embedded conversion option previously accounted for as a derivative instrument under this Subtopic no longer meets the separation criteria under this Subtopic:

a. A description of the principal changes causing the embedded conversion option to no longer require bifurcation under this Subtopic.

b. The amount of the liability for the conversion option reclassified to stockholders' equity.

**ASC 470-20**

35-20 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.

If a previously bifurcated embedded conversion option in convertible debt ceases to meet the ASC 815-15 bifurcation criteria, 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 7.6.4.5 of this Roadmap and Section 6.4 of Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity*). The entity also should provide the disclosures required by ASC 815-15-50-3.
Example 8-27

Convertible Debt With a Conversion Option That No Longer Requires Bifurcation

On January 1, 20X5, Company ABC issues a 10-year note that has a $1,000 par value, accrues interest at an annual rate of 4 percent, and is convertible into 100 shares of ABC common stock. The fair value of one share of ABC's common stock is $8.50 on the issue date. Upon conversion, ABC must settle the accreted value of the note in cash and has the option to settle the conversion spread in either cash or common stock (commonly referred to as Instrument C). In accordance with ASC 815-40, C is not a “conventional convertible” instrument in the application of ASC 815-40 to the conversion option (i.e., ASC 815-40-25-7 through 25-35 does not apply). After considering its potential share requirements for other existing commitments, ABC concludes that it cannot assert that it has a sufficient number of authorized but unissued common shares available to share settle the conversion option; accordingly, the conversion option does not qualify for equity classification under ASC 815-40. After applying ASC 815-40 and ASC 815-15-25-1, ABC concludes that the conversion option must be bifurcated and accounted for as a separate derivative.

At inception, on January 1, 20X5, ABC records the entry below to bifurcate the embedded derivative. Assume that the fair value of the conversion option on that date is $50.

**Journal Entry: January 1, 20X5**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Discount — debt</td>
<td>50</td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td>1,000</td>
</tr>
<tr>
<td>Conversion option liability</td>
<td>50</td>
</tr>
</tbody>
</table>

As of each quarterly reporting date, ABC determines that continued bifurcation of the conversion option is required. For each quarterly reporting period, the derivative (which is not designated as a hedging instrument) is marked to fair value, with the changes in fair value recognized in earnings. Company ABC also recognizes its contractual interest expense on the note, and the debt discount created by the bifurcation of the embedded conversion option is amortized to interest expense. The following journal entries reflect the cumulative activity booked during the year ended December 31, 20X5 (each journal entry represents the sum of the quarterly journal entries):

**Journal Entry: Year Ended December 31, 20X5**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>40</td>
</tr>
<tr>
<td>Cash/interest payable</td>
<td>40</td>
</tr>
<tr>
<td>To recognize contractual interest expense on the debt.</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>5</td>
</tr>
<tr>
<td>Discount — debt</td>
<td>5</td>
</tr>
<tr>
<td>To amortize the discount on the debt created by the bifurcation.</td>
<td></td>
</tr>
<tr>
<td>Change in fair value of conversion liability</td>
<td>150</td>
</tr>
<tr>
<td>Conversion option liability</td>
<td>150</td>
</tr>
<tr>
<td>To mark the conversion option derivative to fair value.</td>
<td></td>
</tr>
</tbody>
</table>

As of December 31, 20X5, the carrying amounts of the debt host contract and the conversion liability are $955 and $200, respectively.
Example 8-27 (continued)

On January 1, 20X6, ABC obtains shareholder approval to increase the number of its authorized common shares to a level sufficient for it to assert that it has the ability to share settle the conversion option. On the basis of this approval, ABC concludes that the conversion option now qualifies for equity classification under ASC 815-40 and that the bifurcated derivative liability no longer needs to be accounted for as a separate derivative under ASC 815-15-25-1.

Company ABC believes that no modification of terms occurred. Rather, an event extraneous to the note (obtaining shareholder approval to increase authorized common shares) has caused the embedded conversion option to no longer meet the conditions for bifurcation.

Company ABC records the following entry on January 1, 20X6 (assume no changes in fair values from December 31, 20X5, to January 1, 20X6).

**Journal Entry: January 1, 20X6**

<table>
<thead>
<tr>
<th>Conversion option liability</th>
<th>200</th>
</tr>
</thead>
<tbody>
<tr>
<td>APIC</td>
<td>200</td>
</tr>
</tbody>
</table>

Note that the debt discount will continue to be amortized over the remaining term of the debt since this discount reflects the issuer's economic borrowing costs related to the convertible debt instrument. Company ABC also would be required to provide the disclosures described in ASC 815-15-50-3.

8.5.5 Inability to Reliably Identify and Measure Embedded Derivative

8.5.5.1 Recognition and Measurement

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-1 An entity shall measure both of the following initially at fair value: . . .</td>
</tr>
<tr>
<td>b. An entire hybrid instrument if an entity cannot reliably identify and measure the embedded derivative that paragraph 815-15-25-1 requires be separated from the host contract.</td>
</tr>
</tbody>
</table>

| 35-2 If an entity cannot reliably identify and measure the embedded derivative that paragraph 815-15-25-1 requires be separated from the host contract, the entire contract shall be measured subsequently at fair value with gain or loss recognized in earnings. Paragraph 815-20-25-71(a)(4) states that the entire contract shall not be designated as a hedging instrument pursuant to Subtopic 815-20. |

In the unusual situation in which an entity cannot reliably identify and measure an embedded feature that is required to be separated as a derivative, the entity must record the entire hybrid instrument at fair value and recognize changes in fair value through earnings. In practice, this provision is rarely applied.

Note that under no circumstance can such an instrument be designated as a hedging instrument under ASC 815-20.
8.5.5.2 Presentation

**ASC 815-15**

45-1 In each statement of financial position presented, an entity shall report hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 815-15-30-1 in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity may do either of the following:

a. Display separate line items for the fair value and non-fair-value carrying amounts
b. Present the aggregate of the fair value and non-fair-value amounts and parenthetically disclose the amount of fair value included in the aggregate amount.

If a debtor accounts for debt at fair value because it either cannot reliably identify and measure an embedded derivative (see Section 8.5.5.1) or has applied the fair value option under ASC 815-15 or ASC 825-10 to the debt (see Sections 4.4 and 8.5.6, respectively), it must report the related fair value amounts separately on the face of the balance sheet under ASC 815-15-45-1.

8.5.5.3 Disclosure

**ASC 815-15**

50-1 For those hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 815-15-30-1, an entity shall also disclose the information specified in paragraphs 825-10-50-28 through 50-32.

50-2 An entity shall provide information that will allow users to understand the effect of changes in the fair value of hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 815-15-30-1 on earnings (or other performance indicators for entities that do not report earnings).

If a debtor accounts for debt at fair value because it cannot reliably identify and measure an embedded derivative (see Section 8.5.5.1), it must provide the disclosures that are required for financial liabilities for which the fair value option in ASC 825-10 has been elected (see Section 14.4.11).

8.5.6 Fair Value Election for Hybrid Financial Instruments

8.5.6.1 Eligibility

**ASC 815-15**

25-4 An entity that initially recognizes a hybrid financial instrument that under paragraph 815-15-25-1 would be required to be separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings and, if paragraph 825-10-45-5 is applicable, other comprehensive income). A financial instrument shall be evaluated to determine that it has an embedded derivative requiring bifurcation before the instrument can become a candidate for the fair value election.
25-5 The fair value election shall be supported by concurrent documentation or a preexisting documented policy for automatic election. That recognized hybrid financial instrument could be an asset or a liability and it could be acquired or issued by the entity. The fair value election is also available when a previously recognized financial instrument is subject to a remeasurement event (new basis event) and the separate recognition of an embedded derivative. The fair value election may be made instrument by instrument. For purposes of this paragraph, a remeasurement event (new basis event) is an event identified in generally accepted accounting principles, other than the recognition of an other-than-temporary impairment, or measurement of an impairment loss through earnings under Topic 321 on equity investments, that requires a financial instrument to be remeasured to its fair value at the time of the event but does not require that instrument to be reported at fair value on a continuous basis with the change in fair value recognized in earnings. Examples of remeasurement events are business combinations and significant modifications of debt as defined in Subtopic 470-50.

Pending Content (Transition Guidance: ASC 326-10-65-1)

25-5 The fair value election shall be supported by concurrent documentation or a preexisting documented policy for automatic election. That recognized hybrid financial instrument could be an asset or a liability and it could be acquired or issued by the entity. The fair value election is also available when a previously recognized financial instrument is subject to a remeasurement event (new basis event) and the separate recognition of an embedded derivative. The fair value election may be made instrument by instrument. For purposes of this paragraph, a remeasurement event (new basis event) is an event identified in generally accepted accounting principles, other than the recording of a credit loss under Topic 326, or measurement of an impairment loss through earnings under Topic 321 on equity investments, that requires a financial instrument to be remeasured to its fair value at the time of the event but does not require that instrument to be reported at fair value on a continuous basis with the change in fair value recognized in earnings. Examples of remeasurement events are business combinations and significant modifications of debt as defined in Subtopic 470-50.

25-6 The fair value election shall not be applied to the hybrid instruments described in paragraph 825-10-50-8.

Under ASC 815-15-25-1, an entity may be required to bifurcate and separately account for an embedded derivative contained within a hybrid instrument. In lieu of such separation, ASC 815-15-25-4 allows an entity to account for the entire hybrid instrument at fair value, provided that the instrument is a financial asset or financial liability, with changes recognized in earnings and, if applicable, OCI.

The fair value election in ASC 815-15 originated from the guidance in FASB Statement 155, which was issued before Statement 159 (which provided the pre-Codification fair value option guidance now contained in ASC 825-10; see Section 4.4). The fair value election in ASC 815-15 can be made on an instrument-by-instrument basis, or an entity can elect this option for all qualifying hybrid financial instruments on some other basis, such as an entity-wide policy decision or a type-of-instrument basis. In all scenarios, the fair value election under ASC 815-15 must be supported with appropriate concurrent documentation that eliminates any question regarding whether the entity elected to apply fair value measurement to a particular instrument.
For the following reasons, the fair value election in ASC 815-15 applies to a narrower population (scope) of items than the fair value option in ASC 825-10:

- The fair value election in ASC 815-15 applies only to hybrid financial instruments for which bifurcation of an embedded derivative would otherwise be required. An entity that elects the fair value option in ASC 825-10 is not required to determine that an embedded derivative would need to be accounted for separately under ASC 815-15.

- ASC 815-15-25-6 prohibits the fair value election for any hybrid instrument that is discussed in ASC 825-10-50-8, which describes 15 items for which public business entities are not required to provide fair value disclosures. The scope of ASC 825-10-50-8 is more restrictive than the scope of the fair value option in ASC 825-10-15-4 and 15-5 (see Section 4.4.2).

Like ASC 825, ASC 815-15 allows the fair value election for an eligible item only upon (1) initial recognition or (2) the occurrence of a subsequent remeasurement event (i.e., a subsequent remeasurement of the entire instrument at fair value under other U.S. GAAP). Therefore, under both ASC 815-15 and ASC 825, an entity is prohibited from making the fair value election upon determining that an embedded derivative that was previously not bifurcated under ASC 815-15 subsequently must be bifurcated (e.g., a hybrid financial instrument containing an embedded derivative that meets the net settlement condition in ASC 815-10-15-83(c) after initial recognition).

There are no situations in which an entity could make the fair value election for a hybrid instrument under ASC 815-15 but would be prohibited from electing the fair value option for the same instrument under ASC 825-10. In addition, regardless of whether the entity applies the fair value accounting guidance in ASC 815-15 or ASC 825, the hybrid financial instrument cannot be designated as a hedging instrument under ASC 815-20. Furthermore, the documentation and disclosure requirements related to the fair value election in ASC 815-15 are the same as those related to the fair value option in ASC 825-10.

Since the fair value election under ASC 815-15 applies to a narrower population of items than does the fair value option under ASC 825, entities can effectively disregard the fair value election guidance in ASC 815-15-25-4. While ASC 815-15 requires an entity to first determine that a hybrid financial instrument contains an embedded derivative for which bifurcation would otherwise be required under ASC 815-15, entities can bypass this assessment because — regardless of whether such bifurcation is required — the hybrid financial instruments that are eligible for the fair value election in ASC 815-15 are also eligible for the fair value option in ASC 825-10 (and the fair value option in ASC 825 can be elected regardless of whether an entity has identified an embedded derivative for which bifurcation would otherwise be required). Furthermore, the disclosure requirements applicable to a hybrid financial instrument for which the fair value election is made under ASC 815-15 are consistent with those in ASC 825-10 (see Section 14.4.11). Regardless of whether fair value accounting is elected under ASC 815-15 or ASC 825-10, an entity is subject to the applicable incremental disclosure requirements for (1) derivatives in ASC 815 and (2) items for which the fair value option has been elected in ASC 825-10. We believe that the guidance on fair value elections in ASC 815-15 (which was derived from FASB Statement 155) was retained in U.S. GAAP because that guidance was available (and may have been used) before the effective date of Statement 159 (codified in ASC 825). Thus, entities may still have hybrid financial instruments that are being recognized at fair value in their entirety in accordance with ASC 815-15 because those instruments were issued before the effective date of the fair value option guidance in ASC 825-10.


### 8.5.6.2 Measurement

**ASC 815-15**

30-1 An entity shall measure both of the following initially at fair value:

- a. A hybrid financial instrument that under paragraph 815-15-25-1 would be required to be separated into a host contract and a derivative instrument that an entity irrevocably elects to initially and subsequently measure in its entirety at fair value (with changes in fair value recognized in earnings) . . .

35-1 If an entity irrevocably elected to initially and subsequently measure a hybrid financial instrument in its entirety at fair value, changes in fair value for that hybrid financial instrument shall be recognized in earnings. Paragraph 815-20-25-71(a)(3) states that the entire contract shall not be designated as a hedging instrument pursuant to Subtopic 815-20.

If an entity elects the fair value option in ASC 815-15 for a hybrid financial instrument, no embedded feature should be separated as a derivative (see Section 8.3.3). The accounting for the hybrid financial instrument is the same as if the fair value option in ASC 825-10 had been applied (see Section 6.3).

### 8.5.6.3 Presentation

**ASC 815-15**

45-1 In each statement of financial position presented, an entity shall report hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 815-15-30-1 in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity may do either of the following:

- a. Display separate line items for the fair value and non-fair-value carrying amounts
- b. Present the aggregate of the fair value and non-fair-value amounts and parenthetically disclose the amount of fair value included in the aggregate amount.

45-2 If an entity has designated a financial liability under the fair value election in accordance with paragraphs 815-15-25-4 through 25-6, the entity shall apply the guidance in paragraph 825-10-45-5 on the presentation of changes in the liability's fair value that result from changes in instrument-specific credit risk.

If a debtor accounts for debt at fair value because it either (1) has applied the fair value option in ASC 815-15 or ASC 825-10 to the debt or (2) cannot reliably identify and measure an embedded derivative that must be separated (see Section 8.5.5), it must report the related fair value amounts separately on the face of the balance sheet under ASC 815-15-25-45-1. The requirements in ASC 825-10 related to the presentation of changes in a liability's fair value that result from changes in instrument-specific credit risk (see Section 6.3.2) apply also to financial liabilities for which the fair value option in ASC 815-15 has been applied.
8.5.6.4 Disclosure

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-1</strong> For those hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 815-15-30-1, an entity shall also disclose the information specified in paragraphs 825-10-50-28 through 50-32.</td>
</tr>
<tr>
<td><strong>50-2</strong> An entity shall provide information that will allow users to understand the effect of changes in the fair value of hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 815-15-30-1 on earnings (or other performance indicators for entities that do not report earnings).</td>
</tr>
</tbody>
</table>

If a debtor elects the fair value option in ASC 815-15, it must provide the disclosures that are required for financial liabilities for which the fair value option in ASC 825-10 has been elected (see Section 14.4.11).
Chapter 9 — Debt Extinguishments

9.1 Background
A debtor accounts for debt as extinguished when the debt has been repaid or the debtor is legally released from its repayment obligation (see Section 9.2 below). The debtor generally recognizes a gain or loss for the difference between the reacquisition price and the net carrying amount of the debt upon an extinguishment (see Section 9.3.1). However, not all extinguishments are accounted for in the same manner (see Sections 9.3.2 through 9.3.8). In certain circumstances, financial liabilities for prepaid stored-value products are derecognized even though they have not been legally extinguished (see Section 9.4). Further, some debt modifications are accounted for as debt extinguishments even though the debt is still outstanding (see Section 10.4.2).

9.2 Extinguishment Conditions

9.2.1 Background
ASC 405-20-40-1 identifies the two circumstances in which a liability should be considered extinguished:

- “The debtor pays the creditor and is relieved of its obligation” (see Section 9.2.3). For instance, a debtor may settle all or a portion of a liability by delivering cash, other financial assets, its own equity shares, goods, or services to the creditor.
- “The debtor is legally released [as] the primary obligor . . . either judicially or by the creditor” (see Section 9.2.4). For instance, debt may be extinguished through a court order, the creditor forgiving the debt, or the assumption of the debt obligation by a third party.

9.2.2 Scope

<table>
<thead>
<tr>
<th>ASC 405-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-1</strong> This Subtopic addresses extinguishments of liabilities. This Subtopic does not address debt conversions or troubled debt restructurings. The accounting guidance for those areas is addressed in Subtopics 470-20 and 470-60.</td>
</tr>
<tr>
<td><strong>05-2</strong> An entity may settle a liability by transferring assets to the creditor or otherwise obtaining an unconditional release. Alternatively, an entity may enter into other arrangements designed to set aside assets dedicated to eventually settling a liability. Accounting for those arrangements has raised issues about when a liability should be considered extinguished. This Subtopic establishes standards for resolving those issues.</td>
</tr>
<tr>
<td><strong>15-2</strong> The guidance in this Subtopic applies to extinguishments of all liabilities, including both financial and nonfinancial liabilities, unless derecognition of a financial or nonfinancial liability is addressed in another Topic (for example, the derecognition guidance for gaming chips in Subtopic 924-405 on casinos or the breakage guidance in Topic 606 on revenue from contracts with customers). Derivative instruments that are nonfinancial liabilities (for example, a written commodity option) are included in the scope of this Subtopic.</td>
</tr>
</tbody>
</table>
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). |
| 15-3 | 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. |

ASC 405-20 applies to financial liabilities, such as debt, and nonfinancial liabilities, except for liabilities that are subject to specific derecognition requirements. For example, liabilities resulting from prepaid stored-value products are subject to different derecognition guidance (see Section 9.4).

As discussed in Chapter 10, ASC 470-50-40-6 through 40-12 contain guidance on the accounting for modifications and exchanges of debt instruments in which the identity of the creditor has not changed. Under that guidance, a debt modification is accounted for as an extinguishment if the modified terms are substantially different from the original terms even if the original debt has not been legally extinguished (see Section 10.4.2). Extinguishment accounting is not applied to an exchange of debt instruments whose terms are not substantially different regardless of whether the original debt has been legally extinguished (see Section 10.4.1). Debt may or may not be considered extinguished when there is a change in the creditor (see Section 10.2.8).

Although ASC 405-20 does not apply to debt conversions, extinguishment accounting does apply to certain exchanges of debt into the issuer’s equity shares. Examples include:

- The settlement of debt through the issuance of equity 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; see Section 9.3.3).
- 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 12.3.3).
- A conversion that occurs in accordance with changed conversion privileges that do not meet the criteria for induced conversion accounting (see Section 12.3.4).
• A conversion that occurs in accordance with the original terms of a conversion feature that represents a share-settled redemption or indexation feature (e.g., the number of shares delivered is determined to have a fair value equal to the redemption amount; see Section 8.4.7.2.5).

• The conversion of debt within the scope of the CCF guidance in ASC 470-20 (see Section 12.6).

Further, it may be appropriate to apply extinguishment accounting to conversions of convertible debt for which the conversion feature was separated as a derivative instrument under ASC 815-15 (see Section 12.4).

The accounting for TDRs is addressed in ASC 470-60 (see Chapter 11).

9.2.3 Condition 1 — Settlement

9.2.3.1 General Considerations

<table>
<thead>
<tr>
<th>ASC 405-20</th>
</tr>
</thead>
</table>
| 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. . . . |

As noted in Section 9.2.1, one scenario in which debt is extinguished under ASC 405-20 is when the debtor is relieved of its obligation through a debt repayment. Examples include:

• The debtor repays the principal amount and any accrued interest at 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 settles the debt after a contingent redemption or acceleration feature is triggered.

• The debtor repurchases outstanding debt securities in a public market for the debt.

• The entity's stockholders or other related parties repay the debt (see Section 9.3.7).
Although not specifically stated in ASC 405-20-40-1, debt might be extinguished by the delivery of the debtor’s equity shares (see Section 9.2.3.2 below). When debt is settled by the delivery of noncash financial assets, the debtor should consider whether the conditions for sale accounting in ASC 860 are met for the transferred financial assets (see Section 9.2.3.3 below). Debt that has been settled should be accounted for as extinguished even if the debtor expects or intends to reissue the debt (see Section 9.2.3.4 below). However, an intention or commitment to settle debt does not represent a debt extinguishment (see Sections 9.2.3.5 and 9.2.3.6). Special considerations are necessary if a debtor acquires a participating interest in its own debt (see Section 9.2.3.7). The settlement of debt after the balance sheet date represents a nonrecognized subsequent event (see Section 9.2.3.8).

9.2.3.2 Settlement in Equity Shares

Under certain GAAP (such as ASC 470-50-40-3), debt can be extinguished by the issuance of common or preferred stock (see Section 9.3.3). For example, an entity might settle debt by issuing equity shares to the creditor that have a value that is equal to the amount due. As discussed in Chapter 12, however, the accounting guidance on debt extinguishments does not apply to certain conversions of debt into the issuer’s equity shares.

9.2.3.3 Settlement Involving Transfer of Noncash Financial Assets

<table>
<thead>
<tr>
<th>ASC 405-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-5 A cash payment or conveyance of noncash financial assets from a debtor to a creditor results in full or partial settlement of the creditor’s receivable from the debtor. Whether or not that settlement is an extinguishment is governed by paragraph 405-20-40-1. However, if a noncash financial asset was conveyed to the creditor in full or partial settlement of a creditor’s receivable, it would be rare to conclude that debt has been extinguished if the criteria of paragraph 860-10-40-5 were not also met.</td>
</tr>
</tbody>
</table>

The extinguishment conditions in ASC 405-20-40-1 apply irrespective of whether the consideration transferred to repay the debt is in the form of cash or noncash assets. For example, a debtor's transfer of noncash financial assets (e.g., debt or equity securities) to settle all or a portion of the debt should be evaluated under those conditions.

If, however, a debtor conveys noncash financial assets to a creditor to settle debt and the transferred financial assets do not meet the conditions for sale accounting in ASC 860-10-40-5, the debtor would be unable to derecognize those transferred assets. As a result, the debtor would either not meet the extinguishment conditions in ASC 405-20-40-1 or would have to recognize another similar liability in accordance with the secured borrowing accounting guidance in ASC 860-30 (see also Section 9.2.4.2).

9.2.3.4 Debt Held for Resale

Under ASC 405-20-40-1(b)(4), debt is considered extinguished if the debtor or its agent buys it back such that the debtor no longer has an obligation to another party. Repurchased debt (or so-called “treasury bonds”) does not qualify as an asset even if it (1) has not been formally retired, (2) is held in treasury and the entity expects to resell it on a future date, (3) is part of a debt issuance that is trading in a public market, or (4) will be held for only a short period.
9.2.3.5 **Intention, Commitment, or Offer to Extinguish Debt**

**ASC 470-50**

**55-9** The following situations do not result in an extinguishment and would not result in gain or loss recognition under either paragraph 405-20-40-1 or this Subtopic:

a. An announcement of intent by the debtor to call a debt instrument at the first call date . . . .

A debtor’s expectation, intention, offer, or firm commitment to settle debt on a future date does not satisfy either extinguishment condition in ASC 405-20-40-1. (However, if the creditor commits to settle debt on terms different from those in the original terms of the debt, the issuer should consider whether the commitment represents a modification to the debt terms that should be accounted for as an extinguishment under ASC 470-50 [see Section 10.2.3].) A debtor should not write off any remaining unamortized premium, discount, or debt issuance costs before debt is considered extinguished for accounting purposes.

Although an extinguishment gain or loss should not be recognized before the extinguishment of debt, the debtor should disclose the terms of the redemption transaction and the anticipated gain or loss in the notes to any interim or annual financial statements issued for periods before the extinguishment. Further, an irrevocable notice to repay the debt before its maturity date may affect the debt’s classification as current or noncurrent under ASC 470-10 (see Chapter 13).

9.2.3.6 **Exercise of Contractual Redemption Feature**

An intention or commitment to exercise a contractual redemption feature does not represent a debt extinguishment under ASC 405-20. For instance, a debt agreement may contain a redemption provision that permits the issuer to redeem the debt on specified terms (e.g., at a price equal to 110 percent of par value plus accrued and unpaid interest) before the debt’s contractual maturity date. Often, such a provision requires the debtor to give notice of legally binding and irrevocable redemption sometime before the actual redemption date. However, the redemption notice would not represent an extinguishment of the debt because it does not legally relieve the debtor of its obligation to pay the debt.

**Example 9-1**

**Irrevocable Notice of Debt Redemption**

Entity A has issued, and has outstanding, $500 million of senior secured notes with a stated maturity of December 31, 2020. The original terms permit A to redeem the notes at a price equal to 113 percent of par value plus accrued and unpaid interest. During the second quarter of 2012, A decides to redeem the notes in accordance with the redemption provisions in the original terms of the debt. On June 30, 2012, A exercises its right under the original terms of the notes to redeem the notes on July 30, 2012. Entity A provides an irrevocable notice of the early redemption to the debt holders on June 30, 2012. Entity A’s early redemption is expected to generate an extinguishment loss of approximately $65 million. The redemption notice is legally binding and irrevocable. Since A exercised its right to redeem the notes early, it reclassified the carrying amount of the notes from long-term to short-term liabilities.

Entity A’s fiscal year-end is December 31, 2012, and its second quarter financial reporting period ended on June 30, 2012, the date of the irrevocable notice to redeem the notes.

Entity A should record an extinguishment gain or loss when the debt has been extinguished for accounting purposes (i.e., in July 2012). The notes are considered extinguished on the date A pays the debt holders and is legally relieved of its obligation. Although the extinguishment loss should not be recognized in the interim financial statements for the second quarter ended June 30, 2012, A should disclose the terms of the redemption transaction and the expected or actual loss, as applicable, in the notes to those interim financial statements.
The exercise of an early redemption provision is not considered a modification or exchange of a debt instrument that should be evaluated under ASC 470-50-40 since such redemption occurs under the debt instrument’s original contractual terms (see Section 10.2.7).

9.2.3.7 Debtor Purchases a Participating Interest in Its Own Debt

Sometimes, a debtor acquires a participating interest in its own outstanding debt. In such circumstances, the debtor should evaluate whether it should derecognize an equivalent portion of the debt.

**Example 9-2**

**Participating Interest in an Entity’s Own Debt**

On January 1, 20X1, Entity B enters into a note payable with Bank C that contains the following terms:

- The principal amount of $500 million is repayable in full on December 31, 20X6.
- Interest is payable quarterly at a per annum rate of LIBOR plus 100 basis points.
- Entity B has the option to prepay the note at any time, in full or in part, without penalty.
- The note is collateralized by a retail office property owned by B.

On June 15, 20X2, the net carrying amount of the note payable on B's balance sheet is $500 million. Entity B has excess cash of $100 million that is available for investment. If B uses this cash to partially prepay the note, there are no prepayment penalties payable to C; however, there is a local transfer tax that becomes payable. Entity B can avoid this transfer tax by purchasing a participating interest in the note from C. Therefore, in lieu of partially prepaying its note payable, B pays C $100 million in return for a participating interest in the note. For simplicity, assume that there are no fees or costs incurred by B to acquire the participating interest.

Entity B has concluded that the conditions in ASC 210-20-45-1 for offsetting the participating interest with the note payable on the balance sheet are not met.

Bank C has concluded that the transfer of the participating interest qualifies for derecognition under ASC 860-10-40-5 and 40-6A. As a result, C recognizes the receipt of the $100 million as a partial sale of its $500 million note receivable from B.

Entity B cannot recognize the $100 million payment to C for a participating interest in its own debt as an asset. Entity B’s purchase of a participating interest in its note payable to C is addressed by ASC 405-20-40-1(a)(4). That is, the participating interest transaction represents the reacquisition by B of a portion of its outstanding debt. Therefore, B must treat the payment of $100 million as a partial extinguishment of its liability for the note payable. This results in B’s reporting a $400 million obligation on its balance sheet. Since B paid $100 million to “extinguish” $100 million of its previously recognized liability, and the carrying amount of that liability is equal to its principal amount (i.e., there are no unamortized premiums, discounts, or issuance costs), there is no gain or loss to be recognized. For income statement reporting purposes in periods after the purchase of the participating interest, B should reflect the interest “earned” on the participating interest as a reduction of the interest “paid” on the note payable. Accordingly, B will recognize interest expense on the net $400 million obligation.

The accounting by B will be symmetrical to the accounting by C. That is, after the participating interest transaction, B reflects a $400 million note payable and C reflects a $400 million note receivable. This symmetry in accounting is consistent with the symmetrical accounting for the transferor and transferee under ASC 860.

The above example discusses a transaction that involves a participating interest in an issuer’s own debt and is not intended to address a similar transaction that does not meet the definition of a participating interest in ASC 860-10-40-6A. For instance, an entity could purchase an interest in its own debt that pays an interest rate that is lower than the interest rate on the debt itself. Such a scenario may occur for various reasons (e.g., the rate differential might reflect a financing of the fees imposed by the creditor to enter into the transaction or a financing of the premium that would otherwise be payable because of a decline in market rates of interest since the origination date of the note).
9.2.3.8 Subsequent Events

An extinguishment of debt after the balance sheet date but before the financial statements are issued (or available to be issued; see Section 13.3.4.9) is a nonrecognized subsequent event under ASC 855. Accordingly, the debt is treated as outstanding in the financial statements. The debtor should consider whether disclosure of the subsequent event is required under ASC 855-10.

9.2.4 Condition 2 — Legal Release

9.2.4.1 General Considerations

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: . . .

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.

As noted in Section 9.2.1, the second scenario in which debt is considered extinguished under ASC 405-20-40-1 occurs when the debtor is legally released as the primary obligor on the debt. Circumstances that may qualify as debt extinguishments under this guidance include those in which:

- The debtor is judicially released, such as the cancellation of debt in a bankruptcy.
- The debtor is legally released by the creditor, such as legal defeasances involving the establishment of a trust that will repay the debt (see Section 9.2.4.2). Since creditors rarely forgive debt without a reason, the debtor should consider whether a debt forgiveness was due to the debtor's financial difficulties (see Chapter 11) or whether other rights or privileges were exchanged that should be given accounting recognition (see Section 3.3).
- A third party assumes the debtor’s nonrecourse debt when the debtor sells an asset that serves as sole collateral for that debt (e.g., certain mortgage loans).
- The debtor becomes secondarily liable as a guarantor (see Section 9.2.4.4).

The determination of whether a debtor has been legally released as the primary obligor under ASC 405-20-40-1(b) is a legal determination that may need to be made on the basis of a legal opinion (see Section 9.2.4.2).

The following do not qualify as debt extinguishments because the debtor has not been legally relieved of its obligation:

- In-substance defeasances of debt involving the establishment of a trust that will repay the debt if the debtor is not legally released of its obligation (see Section 9.2.4.3).
- The issuer’s intention, expectation, or offer to repay the debt (see Section 9.2.3.5).
- The issuer’s irrevocable notice to the holder that it will repay debt in accordance with its contractual terms (see Section 9.2.3.6).
- The debtor’s extinguishment of the debt after the balance sheet date but before the financial statements are issued (see Section 9.2.3.8).
9.2.4.2 **Legal Defeasance**

**ASC 405-20**

55-9 In a legal defeasance, generally the creditor legally releases the debtor from being the primary obligor under the liability. Liabilities are extinguished by legal defeasances if the condition in paragraph 405-20-40-1(b) is satisfied. Whether the debtor has in fact been released and the condition in that paragraph has been met is a matter of law. Conversely, in an in-substance defeasance, the debtor is not released from the debt by putting assets in the trust. For the reasons identified in paragraph 405-20-55-4, an in-substance defeasance is different from a legal defeasance and the liability is not extinguished.

Sometimes, a creditor agrees to release a debtor from being the primary obligor under a debt arrangement even though the debtor has not repaid the creditor. For example, the creditor might agree to release the debtor from its obligation if the debtor (1) sets up an irrevocable trust for the benefit of the creditor (a “defeasance trust”) and (2) the debtor transfers a sufficient amount of cash or other high-quality assets to the trust so that the trust will be able to repay the principal and interest payments on the debt. Further, sometimes debt indentures permit the debtor to legally defease the debt by transferring to a trust either (1) enough cash to purchase Treasury securities that will mature on or before each remaining payment date (interest and principal) in an amount necessary to service those remaining payments or (2) such securities directly. The trust irrevocably pledges the cash flows from the securities to retire the debt.

In these scenarios, debt extinguishment accounting applies if (1) the debtor is not required to consolidate the trust and (2) the arrangement legally releases the debtor from being the primary obligor under the debt. Note, however, that if the debtor’s transfer of assets to the trust do not qualify for derecognition under ASC 860-10, the debtor would be required to recognize another similar liability to the defeasance trust under the ASC 860-30 accounting requirements for transfers of financial assets that do not qualify for sale accounting. If the debtor is required to consolidate the trust, the debt would continue to be reported in the debtor’s consolidated financial statements (see Deloitte’s *A Roadmap to Consolidation — Identifying a Controlling Financial Interest*).

ASC 405-20-40-1(b) specifies that in a transfer of noncash financial assets, the debtor would derecognize the liability if the debtor “is legally released from being the primary obligor under the liability.” Accordingly, the debtor would need to obtain a legal opinion indicating that it, as well as any of its consolidated affiliates, has been released as the primary obligor. The debtor would need to obtain such an opinion even if (1) the debt indenture contains provisions that legally release the obligor if the defeasance trust is properly structured or (2) the debt indenture does not require a legal opinion to be obtained.

If a debtor transfers cash to a defeasance trust, the cash is typically derecognized because transfers of cash are not subject to the sale accounting requirements in ASC 860-10-40-5.
Connecting the Dots

Entities often finance acquisitions, fixed-asset additions, and renovations with long-term debt issued through municipal or industrial revenue bonds. Typically, a qualified governmental agency (the issuer) issues the bond and lends the proceeds to the entity (the obligor). Although the conduit bonds are in the issuer's name, the obligor is solely responsible for repaying the bonds. Obligors sometimes benefit from defeasing the debt before its scheduled retirement. In a defeasance, the bond obligor or its agent purchases securities to deposit into a trust that irrevocably pledges the cash flows from the securities to retire the conduit bonds. The obligor has no continuing involvement with the transferred assets and is not required to consolidate the trusts.

In such circumstances, the debtor would derecognize both (1) its bond obligations and (2) the securities that it has deposited into the trust to service the bonds if the transaction satisfies the derecognition criteria in both ASC 405-20 for liabilities and ASC 860 for financial assets. ASC 405-20-40-1(b) states that in a transfer of noncash financial assets, the obligor can derecognize the bond liability if the obligor “is legally released from being the primary obligor under the liability.” Accordingly, the debtor should obtain a legal opinion even if (1) the municipal bond indentures contain provisions that legally release the obligor if defeasance is properly structured or (2) the bond indenture does not require a legal opinion to be obtained. The debtor also needs to consider the derecognition criteria in ASC 860-10-40-5 for the transfer of a financial asset. Like ASC 405-20-40-1, ASC 860-10-40-5 calls for a legal conclusion — in this instance, regarding whether the transfer isolates the noncash financial assets from the obligor.

9.2.4.3 In-Substance Defeasance

ASC Master Glossary

In-Substance Defeasance

Placement by the debtor of amounts equal to the principal, interest, and prepayment penalties related to a debt instrument in an irrevocable trust established for the benefit of the creditor.

ASC 405-20

55-3 In an in-substance defeasance transaction, a debtor transfers essentially risk-free assets to an irrevocable defeasance trust and the cash flows from those assets approximate the scheduled interest and principal payments of the debt being extinguished.

55-4 An in-substance defeasance transaction does not meet the derecognition criteria in either Section 405-20-40 for the liability or in Section 860-10-40 for the asset. The transaction does not meet the criteria because of the following:

a. The debtor is not released from the debt by putting assets in the trust; if the assets in the trust prove insufficient, for example, because a default by the debtor accelerates its debt, the debtor must make up the difference.

b. The lender is not limited to the cash flows from the assets in trust.

c. The lender does not have the ability to dispose of the assets at will or to terminate the trust.

d. If the assets in the trust exceed what is necessary to meet scheduled principal and interest payments, the transferor can remove the assets.

e. Subparagraph superseded by Accounting Standards Update No. 2012-04.

f. The debtor does not surrender control of the benefits of the assets because those assets are still being used for the debtor's benefit, to extinguish its debt, and because no asset can be an asset of more than one entity, those benefits must still be the debtor's assets.
In an in-substance defeasance, a debtor establishes an irrevocable trust for the benefit of the creditor and transfers to the trust an amount of cash or other assets that is sufficient for repayment of the debt. Unlike a legal defeasance, an in-substance defeasance does not legally release the debtor as the primary obligor under the debt and therefore the debt cannot be treated as extinguished in accordance with ASC 405-20-40-1(b). In the absence of legal release, extinguishment accounting is not appropriate even if the issuer has notified the holder that the third party has assumed the obligation.

If an in-substance defeasance trust does not have the right to sell or repledge assets that a debtor has set aside to satisfy a specific obligation, ASC 860-30-50-1A requires the debtor to disclose the carrying amount and classification of those assets and the associated liabilities as well as a description of the nature of the restrictions placed on the assets.
The extinguishment conditions in ASC 405-20 do not apply to in-substance defeasances of debt that were accounted for as debt extinguishments under FASB Statement 76 before the effective date of FASB Statement 125 (i.e., extinguishments occurring on or before December 31, 1996). If such debt is still outstanding, ASC 470-50-50-1 requires an entity to disclose a general description of the in-substance defeasance transaction and the amount of debt that is accounted for as being extinguished at the end of each period in which the debt remains outstanding.

### 9.2.4.4 Original Debtor Becomes Guarantor

<table>
<thead>
<tr>
<th>ASC 405-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-2</strong> If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment. See Topic 460 for accounting guidance related to guarantees.</td>
</tr>
</tbody>
</table>

Sometimes, another entity assumes primary responsibility for an issuer’s debt instrument and the original issuer becomes legally obligated to make payments on the debt only if the party that has assumed primary responsibility for the debt fails to make payments. In this circumstance, the debtor applies extinguishment accounting to the debt and recognizes a new financial liability for the guarantee obligation at fair value in accordance with ASC 460. The initial fair value amount recognized for the guarantee obligation adjusts the debt extinguishment gain or loss. Subsequently, the guarantee is accounted for in accordance with ASC 460-10-35. See Chapter 5 of Deloitte's *A Roadmap to Accounting for Contingencies, Loss Recoveries, and Guarantees* for further discussion of the recognition and measurement of guarantee liabilities.

### Example 9-3

**Primary Obligor on Debt Becomes Secondarily Liable**

Entity D issues debt to Entity E. Subsequently, Entities D, E, and F execute an agreement under which (1) F assumes primary responsibility for D's obligation to E, (2) D is relieved of that responsibility, and (3) D becomes secondarily liable to E if F fails to pay E. Further, D transfers nonmonetary assets with a fair value of $9.8 million to F as consideration for assuming primary responsibility for the debt obligation. As of the date of the agreement, the current carrying amount of the debt is $10 million and the fair value of D's new obligation is $300,000. The asset transfer qualifies for derecognition under ASC 860-10. Because the fair value of the transferred assets equals their carrying amount, there is no gain or loss on the asset transfer. In this scenario, D would recognize the following accounting entry:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt (at carrying amount)</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Extinguishment loss</td>
<td>100,000</td>
</tr>
<tr>
<td>Guarantee (at fair value)</td>
<td>300,000</td>
</tr>
<tr>
<td>Assets (at fair value)</td>
<td>9,800,000</td>
</tr>
</tbody>
</table>
9.3 Extinguishment Accounting

9.3.1 General

9.3.1.1 Background

ASC 470-50

40-1 As indicated in paragraph 470-50-15-4, the general guidance for the extinguishment of liabilities is contained in Subtopic 405-20 and defines transactions that the debtor shall recognize as an extinguishment of a liability.

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.

Under ASC 470-50-40-2, any difference between the debt’s reacquisition price (see Section 9.3.1.2 below) and its net carrying amount (see Section 9.3.1.3) is recognized as an extinguishment gain or loss in earnings. It is not appropriate to defer recognition of such gain or loss to a future period. For example, a debtor cannot amortize the gain or loss over the remaining life of the extinguished debt or replacement debt issued to fund the proceeds of the extinguishment.

Under ASC 470-50-40-2, debt extinguishment gains and losses must be identified as a separate item. Paragraph 86 of FASB Concepts Statement 6 notes that the appropriate classification of gains and losses as operating or nonoperating depends on “their relation to an entity’s major ongoing or central operations.” Because a debt extinguishment gain or loss is akin to a financing activity, it generally should be classified as part of nonoperating income in the income statement.

9.3.1.2 Reacquisition Price

ASC Master Glossary

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.

The debt’s reacquisition price is the fair value of the consideration transferred to the creditor (e.g., the amount of cash paid or the fair value of any instruments, goods, or services transferred) to extinguish the debt as well as any reacquisition costs (e.g., third-party fees paid). As an exception, the reacquisition price is the fair value of the debt if common or preferred stock is used to settle the debt and the fair value of the debt is more clearly evident than the fair value of the stock (see Section 9.3.3). If the debtor issues new debt to the same creditor to settle debt or modifies existing debt, it should evaluate the transaction under the guidance on debt modifications and exchanges in ASC 470-50-40-6 through 40-12. If the modification or exchange is accounted for as an extinguishment, the reacquisition price is the fair value of the new debt adjusted for the fair value of any other consideration paid to, or received from, the creditor and issuance costs (see Section 10.4.2).
If a debt extinguishment is part of a larger transaction that includes elements not related to the debt extinguishment, those other elements should be given separate accounting recognition. If a portion of the consideration paid by the debtor is related to an asset acquisition or the repurchase of the debtor’s outstanding equity shares, for example, that portion does not form part of the debt’s reacquisition price. In this scenario, the consideration paid is allocated between the debt extinguishment and the other items purchased in the transaction. Similarly, the debtor would need to allocate the consideration paid if it reacquires both debt and outstanding equity shares or contracts on its own equity (e.g., warrants) in the same transaction. The debtor should apply an allocation method, such as relative fair value or a with-and-without method, as appropriate (see Sections 3.4 and 3.5 for analogous guidance).

If an entity extinguishes debt by transferring a noncash asset, the debt’s reacquisition price is the asset’s fair value as of the date of extinguishment. The debt extinguishment gain or loss is calculated on the basis of the difference between the asset’s fair value and the debt’s net carrying amount. The difference between the net carrying amount and the fair value of the asset transferred to extinguish the debt is recognized as a realized gain or loss in earnings. For example, if an entity transferred available-for-sale debt securities to extinguish debt, it would remeasure those securities immediately before the transfer and then recalculate any unrealized gain or loss in OCI to earnings in the same manner as if it sold those securities to third parties. (Note, however, that when noncash financial assets are transferred to extinguish debt, the debtor must ensure that derecognition of those assets is appropriate under other applicable GAAP; see also Sections 9.2.3.3 and 9.2.4.2.)

The gain or loss on an extinguishment of debt in which the debtor transfers its own equity shares is generally calculated on the basis of a comparison of the fair value of the equity shares transferred and the net carrying amount of the debt; however, there is one exception that applies in certain situations (see Section 9.3.3 for further discussion).

### 9.3.1.3 Net Carrying Amount

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Carrying Amount of Debt</strong></td>
</tr>
<tr>
<td>Net carrying amount of debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.</td>
</tr>
</tbody>
</table>

The net carrying amount of debt that is accounted for at amortized cost equals the amount due at maturity adjusted for any remaining unamortized premium or discount or debt issuance costs as of the extinguishment date as determined by using the interest method. It includes any accrued interest to the extinguishment date even if such interest is forfeited upon settlement (i.e., accrued interest is not reversed). Further, the net carrying amount reflects any adjustment to the debt resulting from the application of fair value hedge accounting (see Section 14.2.1.2). If debt contains a bifurcated embedded derivative (e.g., a bifurcated conversion option; see Chapter 8), the current fair value of the embedded derivative as of the extinguishment date is included in the net carrying amount before the extinguishment gain or loss is calculated. Special considerations are necessary if the debt is accounted for at fair value under the fair value option (see Section 9.3.2).
Example 9-4

**Loss on Early Extinguishment of Debt**

On January 1, 20X0, Entity G borrowed $10 million from Bank H for 20 years at an interest rate of 6 percent per annum, which is accounted for at amortized cost. As part of the borrowing transaction, G paid lender fees of $50,000 to H and attorney fees of $20,000 to third parties. Entity G is permitted to prepay the debt at any time for $10.5 million. Entity G determined that the prepayment did not require bifurcation as an embedded derivative under ASC 815-15. Upon issuance, G recognized the following accounting entry:

<table>
<thead>
<tr>
<th>Cash</th>
<th>9,930,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt (discount)</td>
<td>50,000</td>
</tr>
<tr>
<td>Debt (issuance cost)</td>
<td>20,000</td>
</tr>
<tr>
<td>Debt (principal)</td>
<td>10,000,000</td>
</tr>
</tbody>
</table>

On January 1, 20X5, G exercised its prepayment option and repaid the debt for $10.5 million. Under the interest method (see Section 6.2), the debt's net carrying amount as of the extinguishment date was $9,986,528, consisting of the stated principal amount of $10 million less $9,623 of remaining unamortized discount and $3,849 of remaining unamortized debt issuance costs. Because G paid an amount in excess of the debt's net carrying amount, the difference caused a debt extinguishment loss of $513,472 ($10,500,000 – $9,986,528). Entity G recognized the following accounting entry:

| Debt (principal)         | 10,000,000|
| Debt extinguishment loss | 513,472    |
| Debt (discount)          | 9,623      |
| Debt (issuance cost)     | 3,849      |
| Cash                     | 10,500,000 |

If only a portion of an outstanding issue of debt is extinguished, any remaining unamortized discount or premium or issuance costs is allocated between the portion of the debt extinguished and the portion that remains outstanding. Such allocation is typically made on the basis of the relative net carrying amounts. The calculation of the gain or loss on the portion of the debt extinguished reflects the amount of remaining unamortized discount or premium or issuance costs allocated to that portion. The amount of the remaining unamortized discount or premium or issuance costs allocated to the debt that remains outstanding continues to be amortized over the remaining life of that debt.

Example 9-5

**Gain on Early Extinguishment of Debt**

On January 1, 20X0, Entity J issued debt with a principal amount of $100 million in a public offering for proceeds of $102 million, which is accounted for at amortized cost. The debt has a term of 6 years and pays interest at 8 percent per annum. Upon issuance, J makes the following accounting entry:

<table>
<thead>
<tr>
<th>Cash</th>
<th>102,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt (principal)</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Debt (premium)</td>
<td>2,000,000</td>
</tr>
</tbody>
</table>
Example 9-5 (continued)

On January 1, 20X2, J repurchases half of the debt for $50.5 million. The remaining unamortized debt premium on the entire debt issuance is $1,427,964. Accordingly, J allocates that amount between the portion extinguished and the portion that remains outstanding. The difference between the reacquisition price and the net carrying amount of the extinguished portion results in an extinguishment gain of $213,983 ($101,427,964 ÷ 2 – $50,500,000 = $213,982). Entity J recognizes the following accounting entry:

Debt (principal) 50,000,000
Debt (premium) 713,982
Debt extinguishment gain 213,982
Cash 50,500,000

9.3.2  Extinguishments of Debt for Which the Fair Value Option Has Been Elected

ASC 470-50

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.

ASC 825-10

45-6 Upon derecognition of a financial liability designated under the fair value option in accordance with this Subtopic, an entity shall include in net income the cumulative amount of the gain or loss on the financial liability that resulted from changes in instrument-specific credit risk.

If debt is accounted for at fair value by using the fair value option in ASC 815-15 (see Section 8.5.6) or in ASC 825-10 (see Section 4.4), its net carrying amount is its fair value on the reacquisition date. Upon the debt’s extinguishment, the debtor is required to include in net income the cumulative amount of any changes in fair value that are attributable to instrument-specific credit risk and that have been recognized in accumulated other comprehensive income (AOCI). If the debt is repaid at its principal amount at maturity, there would typically not be any remaining component in AOCI related to the cumulative changes in fair value of the financial liability attributable to instrument-specific credit risk (see Section 6.3.2). However, if the debt is extinguished before its stated maturity, there will generally be a component in AOCI that must be reclassified to earnings upon debt extinguishment.
9.3.3   Extinguishments Effected Through the Issuance of Shares

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-2</strong> The guidance in this Subtopic applies, in part, to the following transactions and activities:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>40-3</strong> 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.</td>
</tr>
</tbody>
</table>

Extinguishment accounting applies if a debtor settles outstanding debt by delivering equity-classified shares of common or preferred stock and such settlement is not accounted for as a conversion. However, if the shares issued must be classified as liabilities under ASC 480-10 (e.g., they meet the definition of a mandatorily redeemable financial instrument and are not exempt from the scope of ASC 480; see Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*), the existing debt should be accounted for as extinguished only if the instruments have substantially different terms, as determined under ASC 470-50 (see Section 10.4.2).

If extinguishment accounting applies, the reacquisition price of the extinguished debt is whichever is more clearly evident of either the fair value of the shares issued or the fair value of the debt at the time of the extinguishment. However, under the original terms of some debt instruments, the debtor may deliver a variable number of shares whose value is computed to equal a fixed monetary amount that is based on an average stock price as of a determination date that precedes settlement (e.g., the most recent 20-day volume-weighted average price) rather than the stock price on the settlement date. In such circumstances, in accordance with ASC 480-10-55-22, the debtor should not recognize a gain or loss for a difference between (1) the settlement-date fair value of the shares delivered and (2) the fixed monetary amount. However, an extinguishment gain or loss would still exist for any difference between the fixed monetary amount and the net carrying amount of the debt. The guidance in ASC 480-10-55-22 may not be applied when the settlement does not occur in accordance with the contractual terms of the debt instrument.

For discussion of the accounting for an extinguishment of convertible debt, see Section 9.3.5.

9.3.4   Extinguishments of Hedged Debt

If a debtor extinguishes debt that has been designated as a hedged item in a fair value hedge (e.g., a fair value hedge of fixed-rate debt), the debt's net carrying amount would have been adjusted for the change in the debt's fair value attributable to the hedged risk (see Section 14.2.1.2). Further, the debtor would have been permitted or, if hedge accounting had ceased, required to amortize such fair value adjustments (see ASC 815-25-35-9 and 35-9A). Fair value hedge accounting adjustments are accounted for in the same manner as other components of the debt's carrying amount (see ASC 815-25-35-8). Upon the debt's extinguishment, therefore, the extinguishment gain or loss is calculated on the basis of the net carrying amount as of the extinguishment date after the application of fair value hedge accounting.
If a debtor extinguishes debt that has been designated in a cash flow hedge (e.g., a cash flow hedge of floating-rate debt), the debtor may have deferred amounts in AOCI related to the change in the fair value of the designated hedging instrument that was included in the assessment of hedge effectiveness (see Section 14.2.1.3). Such amounts must be reclassified to earnings if the debt is extinguished (i.e., the debt is settled before maturity); however, such reclassification gain or loss is not classified as part of the debt extinguishment gain or loss (see ASC 815-30-35-44).

9.3.5 Extinguishments of Convertible Debt

9.3.5.1 Background

The accounting for extinguishments of convertible debt (e.g., the repurchase of convertible debt for cash or the settlement of a share-settled redemption feature) depends on whether the debt contains a separately recognized equity component.

9.3.5.2 Convertible Debt Without a Separately Recognized Equity Component

If a debtor extinguishes convertible debt that does not contain a separately recognized equity component, the extinguishment gain or loss is calculated as the difference between the debt's net carrying amount (including the fair value of any bifurcated embedded derivative as of the extinguishment date) and the reacquisition price (see Section 9.3.1.2). This accounting applies even if the debtor pays an amount significantly in excess of the debt's net carrying amount as a result of the fair value of the conversion feature.

Example 9-6

Redemption of Convertible Debt

Entity K has outstanding convertible debt with a net carrying amount of $1,000. The conversion feature is deeply in-the-money because of an increase in K's stock price after the debt was issued. Entity K pays $2,200 to repurchase the debt, which is also the current fair value of the debt. Entity K recognizes the following accounting entry:

Debt 1,000
Debt extinguishment loss 1,200
Cash 2,200
### 9.3.5.3 Convertible Debt With a Separately Recognized Equity Component Other Than a BCF or CCF

#### ASC 815-15

| 40-4 | If a convertible debt instrument with a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to the guidance in paragraph 815-15-35-4 is extinguished for cash (or other assets) before its stated maturity date, the entity shall do both of the following:
|      | a. The portion of the reacquisition price equal to the fair value of the conversion option at the date of the extinguishment shall be allocated to equity.
|      | b. The remaining reacquisition price shall be allocated to the extinguishment of the debt to determine the amount of gain or loss.

A convertible debt instrument that is not within the scope of the guidance on BCFs or CCFs in ASC 470-20 will have a separately recognized equity component only in the following circumstances:

- The convertible debt instrument was issued at a substantial premium (see Section 7.6.3).
- The convertible debt instrument was modified or exchanged in a transaction that did not result in an extinguishment but increased the fair value of the embedded conversion option (Section 10.4.3).
- The embedded conversion option in a convertible debt instrument was previously reclassified from a derivative liability to equity (Section 8.5.4.3).

In these circumstances, any extinguishment of the convertible debt instrument includes settlement of both the liability for the convertible debt instrument and the separate amount recognized in equity. Therefore, the total reacquisition price must be allocated between these two components.

If the equity component is the result of the reclassification of an embedded conversion feature from a derivative liability to equity, the amount allocated to the reacquisition of the equity component equals the fair value of the conversion option on the date of the extinguishment, in accordance with ASC 815-15-40-4. Although not specifically addressed in the Codification, if the separately recognized equity component resulted from (1) a modification or exchange that increased the fair value of the conversion option or (2) a substantial issuance premium, a portion of the reacquisition price equal to the amount that was previously recognized for that separate equity component is allocated to the reacquisition of such equity component, and the remaining portion of the reacquisition price is allocated to the liability for the convertible debt instrument.\(^1\) The amount allocated to the equity component does not result in a gain or loss because ASC 260-10-S99-2 does not apply to the settlement of the equity component if the convertible debt instrument permitted conversion into the issuer’s common stock. However, the amount allocated to the equity component will indirectly affect the extinguishment gain or loss since it reduces the amount allocated to the extinguished debt component.

---

\(^1\) Allocating to the separately recognized equity component an amount equal to the amount initially recognized for that component is different from accounting for a redemption of a convertible debt instrument that contains an embedded conversion option that has been reclassified from a derivative liability to a separate component of equity. This difference is justified because in these situations, only a portion of the entire fair value of the embedded conversion option, as opposed to its entire fair value, is recognized as a separate component of equity.
9.3.5.4 Convertible Debt Within the Scope of the CCF Guidance in ASC 470-20

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-19</strong> 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.</td>
</tr>
<tr>
<td><strong>40-20</strong> 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:</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td>b. Allocate the fair value of the consideration transferred to the holder between the liability and equity components of the original instrument as follows:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>2. Recognize in the statement of financial performance as a gain or loss on debt extinguishment any difference between (i) and (ii):</td>
</tr>
<tr>
<td>i. The consideration attributed to the liability component.</td>
</tr>
<tr>
<td>ii. The sum of both of the following:</td>
</tr>
<tr>
<td>01. The net carrying amount of the liability component</td>
</tr>
<tr>
<td>02. Any unamortized debt issuance costs.</td>
</tr>
<tr>
<td>3. Allocate the remaining settlement consideration to the reacquisition of the equity component and recognize that amount as a reduction of stockholders' equity.</td>
</tr>
<tr>
<td><strong>40-21</strong> 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.</td>
</tr>
<tr>
<td><strong>40-22</strong> 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.</td>
</tr>
</tbody>
</table>

When any instrument that is within the scope of the CCF guidance in ASC 470-20 (see Section 7.6.4) 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) whether the settlement occurs in cash, shares, or a combination of the two. Such settlement transactions include:

- A conversion of an instrument in accordance with its contractual terms.
- A settlement of an instrument for cash in accordance with an embedded call or put option.
- A reacquisition of an instrument before its maturity in an open-market repurchase transaction or other purchase negotiated with the holder.
- A modification or exchange of an instrument that is treated as an extinguishment under ASC 470-50 (see Section 10.4.2).
Upon derecognition of the instrument, the fair value of the consideration transferred (e.g., cash, other assets, equity shares, services, or a combination thereof) is allocated between the two components by using the same method used to allocate the initial proceeds between the two components. The portion of the consideration allocated to the extinguishment of the liability component is equal to the fair value of that component immediately before settlement. The remaining amount of consideration 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 if the convertible instrument permitted conversion into the issuer's common stock.)

Third-party transaction costs that are directly related to the settlement are also allocated to the liability component in proportion to the allocation of consideration transferred to the liability component. 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 allocated to the liability component and (2) the liability component's net carrying amount on the settlement date is recognized as a gain or loss on debt extinguishment. For an example, see Section 6.7.4 of Deloitte's A Roadmap to the Issuer's Accounting for Convertible Debt.

### 9.3.5.5 Convertible Debt With a Recognized BCF Under ASC 470-20

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-3</strong> 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.</td>
</tr>
</tbody>
</table>

If a convertible debt instrument with a recognized BCF (see Section 7.6.5) is extinguished rather than converted, a portion of the consideration paid by the issuer to reacquire the instrument is allocated to the reacquisition 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 settlement-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 of Deloitte's A Roadmap to the Issuer's Accounting for Convertible Debt). 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 9-7

Repurchase of Convertible Debt With a BCF

Entity L buys back, for $100 in cash, outstanding convertible debt whose current net carrying amount is $95. At issuance, L recognized a BCF of $2 related to the debt. The intrinsic value of the conversion option on the repurchase date is $7. Entity L records the following accounting entry upon the reacquisition of the debt:

- Debt: 95
- Equity — APIC (BCF): 7
- Cash: 100
- Debt extinguishment gain: 2

In a manner consistent with the EITF's tentative conclusions on Issue 12 of EITF Issue 00-27 (see Section 7.6 of Deloitte's *A Roadmap to the Issuer's Accounting for Convertible Debt*), this guidance applies even if the extinguishment-date intrinsic value exceeds the commitment-date intrinsic value, but it does not apply if the instrument did not contain a recognized BCF as of the conversion date (e.g., a convertible instrument with a contingent BCF that was never recognized). However, 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 should be limited to the amount initially assigned to the BCF in accordance with ASC 470-20-30-8. In addition, 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 9.3.5.2).

9.3.6 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.

When debt is tendered upon the exercise of detachable warrants, the transaction is accounted for as a conversion (see Chapter 12) and not as an extinguishment if (1) the warrants were originally issued with that debt, (2) the original terms permit the debt to be tendered toward the exercise price of the warrants, and (3) the warrants are classified in equity.
Example 9-8

**Debt Tendered Upon Exercise of Detachable Warrants**

Entity M issues debt with detachable warrants for total proceeds of $10 million, which equals the par amount of the debt, and it elects not to apply the fair value option to the debt. Entity M determines that the warrants qualify as an equity instrument because they are exercisable by the holder into 150,000 shares of M's common stock (par value of $1 per share) for $20 per share, payable in cash or by tendering an equivalent principal amount of the debt. Upon the debt's issuance, M allocates the proceeds between the debt and warrants on a relative-fair-value basis in accordance with ASC 470-20-25-2 (see Section 3.4.2.2). It allocates $8.5 million to the debt and $1.5 million to the warrants and recognizes the following accounting 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>$1,500,000</td>
</tr>
<tr>
<td>APIC</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Debt (principal)</td>
<td>$10,000,000</td>
</tr>
</tbody>
</table>

Three years later, the holder exercises all of the warrants in return for tendering the debt. The remaining unamortized debt discount is $1 million. Entity M recognizes the following accounting entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt (principal)</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Debt (discount)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>$150,000</td>
</tr>
<tr>
<td>APIC</td>
<td>$8,850,000</td>
</tr>
</tbody>
</table>

### 9.3.7 Extinguishments Involving Related Parties

#### 9.3.7.1 Background

Special considerations are necessary for debt extinguishment transactions involving related parties, including extinguishments of debt owed to related parties, an affiliated entity’s acquisition of the entity’s debt from a third party, and the repayment of debt by a related party.

#### 9.3.7.2 Extinguishments of Debt Owed to Related Parties

**ASC 470-50**

40-2 [Extinguishment] transactions between related entities may be in essence capital transactions.

The guidance in ASC 470-50-40-2 has generally been interpreted to suggest that there is a rebuttable assumption that debt extinguishment “gains” in transactions with related parties (e.g., the investor is a significant shareholder, part of management, or an affiliate of the issuer) should be recognized as equity contributions (i.e., in APIC and not in earnings) unless there is substantive evidence that the entity would have obtained the same economic outcome in an arm’s-length transaction. For example, if an entity’s outstanding debt is forgiven by a related party, the credit recognized to reflect the forgiveness should be reflected as an addition to equity. Note, however, that the guidance in ASC 470-50-40-2 generally does not apply when debt issued to a related party is settled in accordance with its contractual terms. In these situations, if there is an equity transaction associated with the debt issuance, it would be recognized upon issuance, not settlement, of the debt.
If a subsidiary's debt is forgiven by its parent for no consideration, the subsidiary should record that forgiveness as a capital contribution from its parent. Evidence that an extinguishment transaction was at arm's length includes a debt settlement that involves related parties and significant third-party investors that receive the same settlement terms (e.g., same reacquisition price).

Generally, debt extinguishment losses in transactions with related parties are recognized in earnings. However, a loss may be recognized in equity as an in-substance dividend if it represents a pro rata distribution to all shareholders.

**Example 9-9**

**Extinguishment of Debt Owed to a Related Party**

Entity N has outstanding debt with a net carrying amount of $100 that is owed to Investor O, which is a significant shareholder. Entity N settles the debt with O for $95. Entity N would not have been able to obtain the same terms from an unrelated party. Accordingly, it records the following accounting entry to reflect the forgiveness of a portion of the debt and a corresponding capital contribution from O:

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>APIC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>95</td>
<td></td>
</tr>
<tr>
<td>APIC</td>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

In his remarks at the 2010 AICPA National Conference on Current SEC and PCAOB Developments, SEC Professional Accounting Fellow Sagar Teotia addressed how the SEC staff expects issuers to determine whether an extinguishment transaction with a related party represents a capital transaction. He noted 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 the following example (footnote omitted):

A Company has non-convertible debt outstanding to a related party (An executive of the Company who is also a significant shareholder). At a later date the related party accepts an offer from the Company to exchange the debt for the Company’s common stock. At the date of exchange, . . . the value of the common stock that was accepted by the related party was significantly lower than the carrying value of the Company’s debt.

At issue is whether the Company’s exchange of common stock for the debt held by the related party should be accounted for as an early extinguishment gain or as a capital contribution. . . .

Based on its analysis, which included the information provided in response to [the] questions [below], the staff believed the substance of the transaction was in essence a capital contribution from a related party.

Further, Mr. Teotia provided the following examples of questions the SEC staff has asked registrants related to this 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.”
### 9.3.7.3 Debt Acquired by Affiliated Entity

In consolidated financial statements, an entity's debt is extinguished if it is held by another member of the same consolidated group. For example, if a parent holds debt issued by its subsidiary, the debt is extinguished in the parent's consolidated financial statements.

If another member of a consolidated group to which the entity belongs acquires the entity's debt from a third party, the debt is accounted for as being extinguished in any consolidated financial statements that include both entities. For example, if a parent acquires debt issued by its subsidiary from a third party, the debt is accounted for as if it had been extinguished in the parent's consolidated financial statements. Note, however, that the debt would still be included in separate financial statements of the debtor if those financial statements do not include the consolidation of the entity that acquired the debt.

#### Example 9-10

**Parent Acquisition of Subsidiary Debt**

Parent P owns an 85 percent interest in the common stock of Subsidiary S. Subsidiary S is included in P's consolidated financial statements and has debt outstanding that trades in an active, public market. Subsidiary S's debt is currently trading at a discount to its par amount. Parent P has purchased some but not all of S's debt in the public market. Parent P intends to temporarily hold the debt and either (1) sell it to S or (2) resell it back into the public market.

In P's consolidated financial statements, the acquisition of S's debt should be accounted for as an extinguishment of debt. Although from S's perspective the debt remains outstanding, the debt has been reacquired by the consolidated entity and, therefore, has been extinguished in the consolidated financial statements of P. Any difference between the carrying amount and the reacquisition price should be accounted for as an extinguishment gain or loss in the consolidated financial statements.

No portion of the extinguishment gain or loss recognized in P's consolidated financial statements would be allocated to the noncontrolling interest in S upon P's purchase of the debt. The holders of the noncontrolling interest in S will not realize any extinguishment gain or loss until S reacquires the debt.

In S's separate financial statements, a debt extinguishment has not occurred and no accounting entry would be recorded. Further, S has not been released from the debt and, accordingly, should continue to reflect the entire balance as outstanding.

If S subsequently reacquires the debt from P in a transaction based on the current fair value of the debt in the public market, S should recognize an extinguishment gain or loss in its separate financial statements on the basis of the difference between the carrying amount of the debt and the reacquisition price paid by S. If S's reacquisition of its debt from P does not occur on the basis of the current fair value of the debt, the difference between the current fair value of the debt and the reacquisition price paid by S should be treated as a capital transaction or as an expense. For example, the difference would be treated as a capital contribution if P were to settle for less than the current fair value of the debt (thereby forgiving a portion of the debt).

### 9.3.7.4 Debt Extinguished by Related Party

**Nonauthoritative AICPA Guidance**

**Technical Q&As Section 4160, “Contributed Capital”**

**.01 Payment of Corporate Debt by Stockholders**

**Inquiry** — Three shareholders own stock in Corporations A and B. They agree to personally pay a debt of Corporation A by giving the creditor stock in Corporation B. How should this transaction be recorded on the books of Corporation A?

**Reply** — The payments by the three stockholders of Corporation A's debt would represent an additional contribution by the stockholders to Corporation A. This can be recorded as a credit to “additional capital.”
If a related party (e.g., a significant shareholder) repays an entity's debt and thereby relieves the entity of its obligation to pay it, the entity should record the transaction as a capital contribution from the related party.

**Example 9-11**

**Debt Repaid by a Related Party**

Entity T has outstanding debt with a net carrying amount of $100. Investor U, a significant shareholder, repays the debt, which relieves T of its obligation to pay it. Entity T does not pay U for the extinguishment. Accordingly, T should record a capital contribution for the benefit received from U:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>100</td>
</tr>
<tr>
<td>APIC</td>
<td>100</td>
</tr>
</tbody>
</table>

**9.3.8  Rate-Regulated Entities**

ASC 980-470

40-1 Subtopic 470-50 requires recognition in income of a gain or loss on an early extinguishment of debt in the period in which the debt is extinguished. For rate-making purposes, the difference between the entity's net carrying amount of the extinguished debt and the reacquisition price may be amortized as an adjustment of interest expense over some future period.

40-2 If the debt is reacquired for an amount in excess of the entity's net carrying amount, the regulator's decision to increase future rates by amortizing the difference for rate-making purposes provides reasonable assurance of the existence of an asset (see paragraph 980-340-25-1). Accordingly, the regulated entity shall capitalize the excess cost and amortize it over the period during which it will be allowed for rate-making purposes.

40-3 If the debt is reacquired for an amount that is less than the entity's net carrying amount, the regulator's decision to reduce future rates by amortizing the difference for rate-making purposes imposes a liability on the regulated entity (see paragraph 980-405-25-1(c)). Accordingly, the entity would record the difference as a liability and amortize it over the period during which permitted rates will be reduced.

ASC 980-470 exempts rate-regulated entities from the requirement to recognize debt extinguishment gains and losses in earnings; such entities may instead amortize gains and losses as an adjustment to interest expense. If the regulator decides to increase future rates for an extinguishment loss, the debtor records an asset and amortizes it over the period in which it is permitted to do so for rate-making purposes. If the regulator decides to reduce future rates for an extinguishment gain, the debtor records a liability and amortizes it over the period in which permitted rates are reduced.

**9.4  Derecognition of Liabilities for Prepaid Stored-Value Products**

**9.4.1  Background**

Prepaid stored-value products are products with a preloaded monetary value (e.g., a gift card, phone card, or traveler's check) that are commonly accepted as a means of payment for goods or services. For example, a prepaid stored-value product might be issued by a financial services company and used as a means of payment at network-accepting merchant locations. Sometimes, the holder also has an option to redeem all or part of the stored monetary value for cash. Unlike a credit card, which is backed by a line of credit, or a debit card, which is linked to a bank account, a prepaid stored-value product typically is prefunded by the initial holder of the product (e.g., through a cash payment).
When an entity sells a prepaid stored-value product, it incurs a liability for the obligation associated with the stored monetary value. If the holder uses all or a portion of the product's stored monetary value to buy goods or services from a third party, the issuer must reimburse the third party. When the issuer settles all or part of its obligation to the third-party provider, a corresponding portion of the issuer's liability is extinguished. However, the issuer often expects “breakage,” which refers to the portion of the stored monetary value that will never be used by holders. For instance, some holders might misplace the product and others might decide not to use the full amount if the remaining balance is small.

ASC 606-10 includes breakage guidance for liabilities associated with revenue contracts with customers (e.g., a retailer’s obligation for a gift certificate that a customer can redeem for goods or services at that retailer). However, ASC 606-10 does not apply to liabilities that meet the definition of a financial liability (such as contractual obligations to pay cash; see Section 2.3.4). Although the holder of a prepaid stored-value product can redeem it for goods or services with a merchant, the issuer has an obligation to pay cash to the merchant. Since a derecognition approach on the basis of a settlement or legal release of an obligation may not reflect the economics of prepaid stored-value products, such liabilities are exempt from the general extinguishment accounting guidance in ASC 405-20-40-1.

9.4.2 Scope

ASC 405-20

40-3 Prepaid stored-value products are products in physical and digital forms with stored monetary values that are issued for the purpose of being commonly accepted as payment for goods or services. While the holder of a prepaid stored-value product also may be permitted to redeem the product for cash, prepaid stored-value products do not include products that only can be redeemed by the product holder for cash (for example, nonrecourse debt, bearer bonds, or trade payables). Examples of prepaid stored-value products include prepaid gift cards issued on a specific payment network and redeemable at network-accepting merchant locations, prepaid telecommunication cards, and traveler’s checks. The derecognition guidance in paragraph 405-20-40-4 does not apply to liabilities related to either of the following:

a. Prepaid stored-value products (or portions of those products) for which any breakage (that is, the portion of the dollar value of prepaid stored-value products that ultimately is not redeemed by product holders for cash or not used to purchase goods and/or services) must be remitted in accordance with unclaimed property laws

b. Prepaid stored-value products that are attached to a segregated bank account like a customer depository account.

The guidance also does not apply to customer loyalty programs or transactions within the scope of other Topics (for example, Topic 606 on revenue from contracts with customers).

The guidance in ASC 405-20 on prepaid stored-value products does not apply to:

- Financial liabilities that can be redeemed for cash only (e.g., nonrecourse debt, bearer bonds, and trade payables). The extinguishment conditions in ASC 405-20-40-1 (see Section 9.3) apply to such liabilities.

- Financial liabilities “for which any breakage . . . must be remitted in accordance with unclaimed property laws.” Since unclaimed property laws vary among jurisdictions, an issuer may have breakage liabilities that are subject to different legal requirements. The determination of whether unclaimed property laws apply to a specific breakage liability is a legal question that may need to be evaluated with the assistance of legal specialists.
• Financial liabilities related to “[p]repaid stored-value products that are attached to a segregated bank account like a customer depository account.” For example, the guidance does not apply to a debit card that is attached to a bank account.

• Obligations under customer loyalty programs, such as frequent flier miles and credit card reward programs (see Deloitte’s *A Roadmap to Applying the New Revenue Recognition Standard*).

• Transactions within the scope of other GAAP, such as closed-system prepaid gift cards that are issued by a merchant to permit the holder to purchase goods or services from that merchant in the future; see Deloitte’s *A Roadmap to Applying the New Revenue Recognition Standard*.

### 9.4.3 Accounting

<table>
<thead>
<tr>
<th>ASC 405-20</th>
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</thead>
<tbody>
<tr>
<td><strong>40-4</strong> If an entity expects to be entitled to a breakage amount for a liability resulting from the sale of a prepaid stored-value product in the scope of paragraph 405-20-40-3, the entity shall derecognize the amount related to the expected breakage in proportion to the pattern of rights expected to be exercised by the product holder only to the extent that it is probable that a significant reversal of the recognized breakage amount will not subsequently occur. If an entity does not expect to be entitled to a breakage amount for prepaid stored-value products in the scope of paragraph 405-20-40-3, the entity shall derecognize the amount related to breakage when the likelihood of the product holder exercising its remaining rights becomes remote. At the end of each period, an entity shall update the estimated breakage amount to represent faithfully the circumstances present at the end of the period and the changes in circumstances during the period. Changes to an entity's estimated breakage amount shall be accounted for as a change in accounting estimate in accordance with paragraphs 250-10-45-17 through 45-20.</td>
</tr>
<tr>
<td><strong>50-2</strong> An entity that recognizes a breakage amount in accordance with paragraph 405-20-40-4 shall disclose the methodology used to recognize breakage and significant judgments made in applying the breakage methodology.</td>
</tr>
</tbody>
</table>

ASC 405-20 requires an issuer to recognize breakage associated with prepaid stored-value products (see *Section 9.4.2*) in a manner similar to breakage associated with revenue transactions within the scope of ASC 606-10 (see Deloitte’s *A Roadmap to Applying the New Revenue Recognition Standard*). Under the breakage guidance in ASC 405-20, an issuer of a prepaid stored-value product must first determine whether it expects to be entitled to a breakage amount. Expected breakage amounts can only be recognized to the extent that it is probable that a significant reversal of the recognized breakage amount will not subsequently be required. In evaluating whether it is entitled to a breakage amount, the issuer may, by analogy to ASC 606-10-55-48, consider factors similar to those in ASC 606-10-32-12. That guidance provides examples of “[f]actors that could increase the likelihood or the magnitude of a . . . reversal,” including the following:

• “The uncertainty about the amount . . . is not expected to be resolved for a long period of time.”

• “The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.”
If the issuer expects to be entitled to a breakage amount, it derecognizes a portion of its liability for the prepaid stored-value product over time to reflect expected breakage amounts. Breakage is not recognized immediately upon issuance of the prepaid stored-value product. Instead, expected breakage amounts are recognized over time in proportion to the pattern of rights expected to be exercised by the holder (i.e., in proportion to amounts redeemed). At the end of each reporting period, the issuer updates its breakage estimates to reflect current circumstances and accounts for the changes as a change in accounting estimate under ASC 250-10-45-17 through 45-20.

**Example 9-12**

**Derecognition of Prepaid Gift Cards — Breakage Anticipated**

On the basis of a portfolio assessment, an issuer of prepaid gift cards within the scope of ASC 405-20 expects breakage of 20 percent of the initial dollar balance on each card. Upon issuance of a gift card, the issuer recognizes the full stated balance as the initial carrying amount of its liability for the gift card. Each time holders redeem gift cards and the issuer pays its associated obligation, the issuer derecognizes a portion of its liability for prepaid gift cards equal to the amount extinguished, plus an additional amount equal to 25 percent of amounts redeemed, to reflect expected breakage (20% ÷ 80%). When a gift card holder redeems $80 of the card balance to purchase goods or services from a third-party merchant, the issuer reimburses the merchant in $80 of cash. Accordingly, the issuer derecognizes $80 of its liability to reflect the amount extinguished and derecognizes another $20 to reflect expected breakage (25% × $80). When a gift card holder redeems another $160, another $40 of breakage is recognized (25% × $160). If the pattern of rights expected to be exercised by holders slows so that expected breakage declines to 70 percent of initial dollar balances, the issuer accounts for the change as a change in estimate under ASC 250-10.

If the issuer does not expect to be entitled to a breakage amount, it derecognizes a portion of its liability to reflect such an amount only when the likelihood that the holder will exercise its remaining rights becomes remote.

**Example 9-13**

**Derecognition of Prepaid Gift Cards — Breakage Not Anticipated**

An issuer of prepaid gift cards within the scope of ASC 405-20 does not expect to be entitled to any breakage. Upon the cards’ issuance, the issuer recognizes the full stated balance as a liability. Over time, the issuer derecognizes any amount that it settles. Any remaining unused balance is derecognized only when the likelihood is remote that such amounts will ultimately be redeemed.
Chapter 10 — Debt Modifications and Exchanges

10.1 Background
This chapter discusses the accounting for modifications and exchanges of debt, lines of credit, revolving debt, and term loan commitments.

10.2 Scope

10.2.1 General

<table>
<thead>
<tr>
<th>ASC 470-50</th>
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</thead>
<tbody>
<tr>
<td>05-2</td>
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<td>40-8</td>
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</table>

ASC 470-50-40-6 through 40-20 address the debtor’s accounting for (1) modifications of the terms of existing debt instruments and (2) exchanges of debt instruments with the same creditor. This guidance, which applies to all entities, also addresses:

- The contemporaneous exchange of cash and debt instruments with the same creditor (see Section 10.2.2).
- A binding commitment to modify, exchange, or redeem debt on terms that differ from the original debt terms (see Section 10.2.3).
- The payment of consent fees to obtain a waiver of a covenant violation (see Section 10.2.4).
- For consolidated financial statements, the exchange of debt issued by one entity within the consolidated group for debt issued by another entity within that group (see Section 10.2.10).
- An exchange of debt for liability-classified shares of common or preferred stock (see Section 10.2.12).

ASC 470-50 does not address:

- Nonbinding offers to modify, exchange, or redeem debt (see Section 10.2.3).
- TDRs (see Section 10.2.5 and Chapter 11).
- Debt modifications or exchanges at or near the maturity date of the original debt (see Section 10.2.6).
• Prespecified changes in cash flows as a result of the application of contractual provisions (e.g., the exercise of a contractual redemption feature; see Section 10.2.7).

• Transactions among debt holders (see Section 10.2.8).

• Transactions with parties other than the creditor (see Section 10.2.9).

• Conversions of debt into equity-classified shares of preferred or common stock (see Section 10.2.11).

• Exchanges of debt for equity-classified common or preferred shares (see Section 10.2.12).

• The creditor’s accounting for modifications and exchanges of investments in debt instruments.

• Modifications or exchanges of derivatives (e.g., forwards, swaps, warrants, or options).

Further, a debtor may elect not to apply the guidance in ASC 470-50 to certain market issuances of new debt to replace old debt (see Section 10.2.13).

In March 2020, the FASB issued ASU 2020-04, which permits debtors to elect not to apply extinguishment accounting to certain debt modifications made in connection with reference-rate reform even if ASC 470-50 would have required such accounting to be applied (see Section 14.2.5).

### 10.2.2 Contemporaneous Exchange of Cash and Debt Instruments

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-9</strong> 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 would only be accounted for as debt extinguishments if the debt instruments have substantially different terms, as defined in this Subtopic.</td>
</tr>
</tbody>
</table>

When a debtor repays debt for cash, the debt is generally considered extinguished (see Section 9.2). However, if a debtor (or its agent; see Section 10.5) repays outstanding debt for cash and contemporaneously issues new debt to the same creditor for cash, the net effect of the two transactions is an exchange of debt instruments. Therefore, the transactions generally need to be analyzed on a combined basis in accordance with the guidance in ASC 470-50.

In evaluating multiple transactions between the same debtor and creditor under ASC 470-50-40-9, an entity must consider whether the transactions were executed both contemporaneously and in contemplation of each other (i.e., contingent on one another). While it would generally be difficult to establish that contemporaneous transactions between a debtor and a creditor were not contingent on one another, the relevant facts and circumstances must be evaluated. For example, the following factors may suggest that two transactions should not be combined:

- Lack of legal or contractual linkage between the transactions.
- A sufficient period has elapsed between the two transactions during which the debtor and creditor are exposed to the risk that the second transaction will not take place (i.e., the second transaction is not firmly committed).

Under ASC 470-50, a debtor accounts for an exchange of debt instruments as an extinguishment of the existing debt instrument if the debt instruments have substantially different terms (see Section 10.4.2). A contemporaneous exchange of cash and debt instruments with the same creditor is accounted for as a modification of the original debt if the terms are not substantially different (see Section 10.4.3).
ASC 470-50-40-9 does not apply when new debt is issued to a different creditor. When a debtor or its agent repays debt by using proceeds from debt issued to a different creditor, the original debt is accounted for as extinguished (see Section 9.3) even if there have been no or only insignificant changes to the debt terms.

10.2.3 Intention, Offer, or Commitment to Modify, Exchange, or Redeem Debt

ASC 470-50

55-8 This Subtopic applies to transactions 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.

55-9 The following situations do not result in an extinguishment and would not result in gain or loss recognition under either paragraph 405-20-40-1 or this Subtopic:

a. An announcement of intent by the debtor to call a debt instrument at the first call date . . . .

If a debtor (or its agent; see Section 10.5) enters into a binding agreement with a creditor to redeem or exchange debt or otherwise modify its terms, the binding agreement represents a debt modification that should be evaluated under ASC 470-50. Therefore, the debtor should determine whether the debt terms as modified by the binding agreement are substantially different from the original debt terms (see Section 10.4).

The debtor’s mere announcement that it expects or intends to modify, exchange, or redeem debt is not evaluated as a modification or exchange under ASC 470-50. If a debtor provides the creditor with an offer to redeem the debt or otherwise modify the debt terms or exchange the debt and the creditor has not accepted the offer, a debt modification has not occurred. Therefore, ASC 470-50 does not apply. However, if a creditor accepts the offer and the revised debt terms therefore become binding on both the debtor and creditor, the debtor should determine whether the revised debt terms are substantially different from the terms of the original debt instrument (see Section 10.3).

10.2.4 Consent Fees Paid by a Debtor to Obtain a Covenant Waiver

An entity might pay fees or other consideration, such as warrants and options, to a creditor to compensate for a violation of a debt covenant. If the fee was not part of the original debt terms but was negotiated at the time of the violation, it represents a modification that should be evaluated under ASC 470-50. Such fees and other noncash consideration should be reflected in the performance of the 10 percent cash flow test (see Section 10.3.3.2.4).

If a modification or exchange is accounted for as a debt extinguishment, the debtor should apply the guidance in ASC 470-50-40-17(a) on debt extinguishments and include the fee paid in the calculation of the debt extinguishment gain or loss (see Section 10.4.2). Otherwise, it applies ASC 470-50-40-17(b), which states that an entity should defer such fees along with any existing unamortized premium and discount and use the interest method to amortize them as an adjustment to interest expense over the remaining life of the modified debt instrument (see Section 10.4.3).
10.2.5 Troubled Debt Restructurings

**ASC 470-50**

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

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.) . . .

ASC 470-50 does not apply to modifications or exchanges that qualify as TDRs. For a detailed discussion of the scope of the TDR guidance, see Section 11.2.

**ASC 470-60**

55-5 The following model should be applied by a debtor when determining whether a modification or an exchange of debt instruments is within the scope of this Subtopic.

10.2.6 Modifications or Exchanges at or Near the Debt’s Maturity

ASC 470-50 does not apply to the modification of debt or to its exchange with an existing creditor at or near the debt's stated maturity. If a modification or exchange of debt at or near its stated maturity does not represent a TDR (see Section 11.2), it should be treated as an extinguishment (see Section 9.3). The debtor recognizes the new debt instrument at fair value and the difference between this amount and the net carrying amount of the extinguished debt is recognized as an extinguishment gain or loss.
This guidance is consistent with ASC 470-20-30-19 through 30-21:

**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. [Emphasis added]

**10.2.7 Application of Contractual Provisions**

Prespecified changes to the cash flows of a debt instrument that result from the application of an existing contractual term (e.g., the exercise of an option or trigger of a contingent payment feature under a debt instrument's original terms) generally do not represent debt modifications. For instance, the exercise of a prepayment option that permits the debtor to prepay all or a portion of the debt's principal balance is not evaluated as a modification. Similarly, the exercise of a right to convert a variable-rate debt instrument into a fixed-rate instrument or the payment of contingent interest upon the occurrence of an event of default is not treated as a debt modification. Changes to the cash flows of a debt instrument that result solely from the application of contractual terms of a debt instrument should be reflected in the application of the interest method (see Section 6.2) and should also be evaluated for separation under ASC 815-15 (see Chapter 8). Special considerations are necessary if a debtor or creditor exercises a contractual provision in conjunction with a modification or exchange (see Section 10.3.3.2.3).

**Example 10-1**

**Change in Terms of Auction Rate Securities**

Company B has issued various series of auction rate securities (ARSs). The ARSs were not issued at a discount or premium, and the terms of the securities require the coupon rate to reset through a Dutch auction process. Once reset, the coupon rate will remain the same until the next auction.

The period between auctions is referred to as the “reset frequency” or “mode.” The terms of the agreement allow B to change the mode from three to six months by providing the holders of the securities with notice of B's intention to do so 30 days before the effective date of the mode change.

Recently, the auction for B's debt securities failed, which has triggered a provision in the agreement that automatically increases the coupon rate for each debt security in the series to a penalty rate of 20 percent. In accordance with the terms of the agreement, B has notified the holders of the debt securities of its intention to increase the mode from three to six months.

Company B's decision to increase the mode from three to six months does not represent a modification to the agreement that should be accounted for in accordance with ASC 470-50, because the agreement allows B to change the mode from three to six months.
Example 10-1 (continued)

Whether the extension of the mode of an ARS is a modification depends on whether the agreement allows the issuer to unilaterally extend the mode or the range over which the mode may be extended. If an agreement allows extension of the mode and the new mode is within the allowable range, the extension is not considered a modification that requires further analysis.

However, if the agreement does not allow the issuer to unilaterally extend the mode, or if the mode is extending beyond the allowable range, the issuer should determine whether the extension is a modification requiring analysis under ASC 470-50. For example, if the agreement allows an extension of the mode but the new reset frequency is not within the agreement’s allowable range, the extension would be a modification of the original indenture and would require analysis under ASC 470-50.

10.2.8 Transactions Among Debt Holders

ASC 470-50

40-7 Transactions among debt holders do not result in a modification of the original debt's terms or an exchange of debt instruments between the debtor and the debt holders and do not impact the accounting by the debtor.

55-6 If a debt instrument is transferred from one debt holder to another in connection with a modification or exchange, including transfers from an intermediary acting as principal to another debt holder, the debtor is not impacted by the exchange as long as the funds do not pass through the debtor or its agent.

ASC 470-50 does not apply to transactions in which the debtor is not a party. When a creditor sells or otherwise transfers debt to a different entity without any involvement of the debtor, there is no accounting required by the debtor (i.e., the debt is not accounted for as having been modified or extinguished even though the creditor has changed).

However, if a debtor or its agent receives or pays cash in connection with a transfer of debt between debt holders (e.g., as a transfer consent fee) or the terms are modified in connection with such a transfer (e.g., to remove transfer restrictions), the debtor should consider whether the substance of the transaction is a repayment of the existing debt by using proceeds from debt issued to a different creditor (which would be accounted for as an extinguishment of the original debt; see Section 9.3) or a modification of the debt terms (which would be evaluated under ASC 470-50). If a holder of debt initiates the transaction and pays the debtor a fee solely to remove a transfer restriction in connection with its transfer of the debt to a different holder, the substance of the transaction is likely that of a modification of existing debt, which should be evaluated to determine whether it should be accounted for as a modification or extinguishment under ASC 470-50. However, if a debtor initiates the transaction and the funds pass through the debtor or its agent, the substance of the transaction may be that of a repayment of the existing debt and the issuance of new debt to a different holder.

If a contractual modification and transfer of a debt instrument, in substance, represents a market issuance of new debt to replace old debt, the debtor may elect to treat it as an extinguishment of the original debt even if no funds pass through the debtor or its agent. This guidance is only applicable if the terms of the new debt are equivalent to those of an arm’s-length market offering (e.g., market yield and credit spread) that is independent of the redemption of the old debt (see Section 10.2.13).
10.2.9 Transactions With Third Parties

**ASC 470-50**

15-3 The guidance in this Subtopic does not apply to the following transactions and activities: . . .
   c. Transactions entered into between a debtor or a debtor’s agent and a third party that is not the creditor.

55-9 The following situations do not result in an extinguishment and would not result in gain or loss recognition under either paragraph 405-20-40-1 or this Subtopic: . . .
   c. An agreement with a creditor that a debt instrument issued by the debtor and held by a different party will be redeemed.

ASC 470-50 does not apply to transactions between the debtor (or its agent) and a party other than the holder of the debt unless that other party is acting as the holder’s agent in the transaction (see Section 10.5.2). For example, if a debtor enters into a call option or forward purchase agreement that would result in a debt redemption upon settlement, that transaction would not be evaluated under ASC 470-50 if the counterparty does not hold the debt that is subject to redemption.

10.2.10 Exchanges of Debt Issued by Different Entities Within a Consolidated Group

In consolidated financial statements, the debt of any entity within the consolidated group represents debt of the reporting entity. If debt issued by one entity within the group (e.g., a subsidiary) is exchanged for debt issued by another entity within the group (e.g., the parent), that debt exchange should be evaluated under ASC 470-50 to determine whether extinguishment or modification accounting is appropriate in the consolidated financial statements that include both of those entities. However, ASC 470-50 does not apply to financial statements that do not include both entities.

10.2.11 Convertible Debt

**ASC 470-50**

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. . . .

**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 an issuer modifies or exchanges an outstanding convertible debt instrument, it should assess whether the transaction should be accounted for as a modification or an extinguishment of the original instrument under ASC 470-50. This guidance does not apply to:

- Conversions that occur under the original terms of the instrument (see Chapter 12).
- Changes to the terms of the conversion privileges that represent an induced conversion under ASC 470-20 (see Sections 12.3.4 and 12.6.2).
- 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 is not evaluated as a modification under ASC 470-50. Instead, the issuer should evaluate such provisions under other applicable GAAP.

### 10.2.12 Exchanges of Debt for Common or Preferred Stock

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-2</strong> The guidance in this Subtopic applies, in part, to the following transactions and activities:</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

If a debtor settles outstanding debt by issuing equity-classified shares (including equity instruments classified in temporary equity), the guidance on modifications and exchanges in ASC 470-50 does not apply. Instead, the exchange is accounted for as a debt extinguishment under ASC 470-50-40-3 (see Section 9.3.3) unless it is a TDR (see Chapter 11) or represents a conversion (see Chapter 12).

If outstanding debt is exchanged for shares that must be classified as liabilities under ASC 480-10 (i.e., mandatorily redeemable financial instruments and certain variable-share obligations; see Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*), the guidance on modifications and exchanges of debt in ASC 470-50 should be applied.

### 10.2.13 Market Issuances of New Debt to Replace Old Debt

If a debtor issues new debt and uses some of the proceeds to contemporaneously repurchase some or all of its existing debt according to preexisting redemption terms, the debtor would not necessarily be required to view all or a portion of those transactions as a debt exchange to which ASC 470-50 applies even if some or all of the new debt is purchased by investors that redeemed their existing debt. Instead, it is acceptable for the debtor to evaluate the substantive terms of the transactions to determine whether they should be analyzed as either (1) an extinguishment of the existing debt under ASC 405-20 and the separate issuance of new debt (see Chapter 9) or (2) an exchange of debt instruments under ASC 470-50-40-6 through 40-12 for the portion of new debt held by continuing investors.

In determining whether transactions with continuing investors should be analyzed as a debt exchange under ASC 470-50, the debtor should evaluate whether the redemption of the old debt and issuance of the new debt were negotiated in contemplation of one another (i.e., contingent upon one another). While this evaluation can be complex because it involves debt issued to multiple investors, if the facts suggest that the new debt offering was an arm’s-length market offering that did not depend on the redemption of the old debt, it is acceptable to treat the redemption of the old debt and issuance of new debt as separate transactions even if some or all of the proceeds were used to exercise a contractual right to repay all or a portion of preexisting debt. It would also be acceptable to apply ASC 470-50 on a creditor-by-creditor basis to the extent that the same investor(s) held old debt and purchased new debt.
An entity's decision to apply extinguishment accounting to all of the old debt as opposed to applying ASC 470-50 on a creditor-by-creditor basis is an accounting policy decision that must be consistently applied.

### Example 10-2

#### Market Issuance of New Debt to Repay Outstanding Debt

On March 1, 20X4, Entity C engages a bank to place $300 million of new debt into the market and use the proceeds to repurchase some of C’s old debt. Given the interest rate environment and the company’s financial condition, C believes that it can obtain a lower long-term financing cost by undertaking these transactions. Also assume the following:

- The redemption of the old debt was in accordance with a preexisting early-redemption option in the original debt agreement (as opposed to a separately negotiated early redemption).
- The issuance of new debt was offered to all potential qualified investors in the marketplace, including, but not exclusively, any investors that held the old debt. None of the investors in the old debt were required to participate in the issuance of the new debt. In addition, the holders of the old debt were not involved in the negotiations of the terms and conditions of the new debt (unless one of the debt holders acted in a placement-agent capacity for the new debt).
- The purchase of new debt by investors that held the old debt was an investment decision that is separate from the redemption of the old debt.
- No preferential treatment was given to investors in the old debt (i.e., old and new investors were offered the same terms in the new debt offering).
- There was inherently going to be overlap between the investors in the old and new debt because a large percentage of investors in the marketplace held the old debt.
- New investors purchased more than an insignificant portion of the new debt.

Entity C is therefore not required to apply ASC 470-50 to the portion of the old debt that has been redeemed and is held by investors in the new debt. Instead, it may apply extinguishment accounting to all of the old debt. It is also acceptable to apply ASC 470-50 on a creditor-by-creditor basis to the extent that the same investor(s) held old debt and purchased new debt. An entity's decision to apply extinguishment accounting to all of the old debt as opposed to applying ASC 470-50 on a creditor-by-creditor basis is an accounting policy decision that must be consistently applied.

### 10.3 Determining Whether Debt Terms Are Substantially Different

#### 10.3.1 Background

If a debtor modifies or exchanges an outstanding debt instrument with the same creditor in a transaction that is not a TDR (see Chapter 11), the accounting depends on whether the original and new debt terms are substantially different. The guidance that applies to modifications and exchanges is the same because they have the same economic effect, and in both cases, the debtor continues to have debt outstanding with the same creditor on revised terms.

Under ASC 470-50, debt terms are considered substantially different in each of the following circumstances:

- The 10 percent cash flow test is passed (see Section 10.3.3).
- The fair value of an embedded conversion option changes by at least 10 percent of the carrying amount of the original debt instrument (see Section 10.3.4.2).
- A substantive conversion option is added to, or eliminated from, the debt terms (see Section 10.3.4.3).
If the new debt terms are substantially different from the original debt terms, the original debt is accounted for as being extinguished and a new debt instrument is recognized (see Section 10.4.2). If the new debt terms are not substantially different from the original debt terms, the transaction is accounted for as a modification of the original debt terms (see Section 10.4.3).

### 10.3.2 Level of Aggregation

#### 10.3.2.1 Background

A debtor needs to determine the appropriate level of aggregation for its analysis of any modification or exchange if a particular debt instrument is held by more than one creditor (see Section 10.3.2.2 below) or a creditor holds more than one debt instrument (see Section 10.3.2.3). Special considerations are necessary for loan participations and loan syndications (see Section 10.3.2.4).

#### 10.3.2.2 Multiple Holders of Identical Debt Instruments

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public Debt Issuance</strong></td>
</tr>
<tr>
<td>A public debt issuance occurs when a debtor issues a number of identical debt instruments to an underwriter that sells the debt instruments (in the form of securities) to various investors.</td>
</tr>
</tbody>
</table>

| ASC 470-50                                                                                                    |
| 55-3 In a public debt issuance, for purposes of applying the guidance in this Subtopic, the debt instrument is the individual security held by an investor, and the creditor is the security holder. If an exchange or modification offer is made to all investors and only some agree to the exchange or modification, then the guidance in this Subtopic shall be applied to debt instruments held by those investors that agree to the exchange or modification. Debt instruments held by those investors that do not agree would not be affected. |

When identical debt instruments are held by more than one creditor (e.g., in a public debt issuance), the debtor applies the modification and exchange guidance in ASC 470-50 separately to the debt held by each individual creditor (i.e., on a creditor-by-creditor basis). If all holders do not participate in the modification or exchange, the debtor applies ASC 470-50 only to debt held by those creditors that participate. Thus, if a debt arrangement involving multiple lenders is structured as a loan participation, the debtor has only one creditor (see Section 10.3.2.4).

If a collective assessment would produce the same outcome as an individual assessment (e.g., all holders that participate in a modification or exchange of identical debt instruments receive the same new debt terms), a debtor does not need to perform separate assessments for each individual creditor that participates in the transaction to determine whether to account for that creditor’s debt as an extinguishment. However, if different creditors (or creditor groups) obtain different debt terms under a modification or exchange, or the effective interest rate on debt held by different creditors is not the same, the debtor would need to apply ASC 470-50 separately to each creditor or creditor group.

As discussed in Section 10.2.13, a debtor is not required to apply ASC 470-50 to certain market issuances of new debt to replace old debt even if some creditors hold both the original and new or modified debt.
**10.3.2.3 Multiple Debt Instruments Held by the Same Creditor**

Sometimes, one creditor (or multiple creditors within a consolidated group or otherwise under common control) holds multiple debt instruments issued by the same debtor. If a modification or exchange involves more than one existing debt instrument (or more than one new debt instrument), a debtor should apply judgment and consider the economic substance of the transaction to determine whether the modification or exchange should be evaluated on the basis of an aggregation of individual debt instruments. In many cases, the evaluation will be performed on an aggregated basis because either (1) it is not possible to perform the evaluation on an individual-instrument basis (e.g., two existing debt instruments are exchanged for one new instrument) or (2) the transaction was negotiated as an overall package (e.g., the debtor accepts less favorable terms on one debt instrument in exchange for more favorable terms on a different debt instrument). Aggregating debt instruments in the application of ASC 470-50 is consistent with the accounting for multiple transactions executed contemporaneously or in contemplation of one another (i.e., contingent upon one another). While it would generally be difficult to establish that contemporaneous transactions between a debtor and a creditor were not contingent on one another, other relevant facts and circumstances involving the transactions may suggest otherwise. In performing the 10 percent cash flow test, the debtor would calculate and use a composite effective interest rate for any debt instruments that are evaluated on an aggregated basis (see Section 10.3.3.3).

**10.3.2.4 Loan Participations and Loan Syndications**

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loan Participation</strong></td>
</tr>
<tr>
<td>A transaction in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to groups of banks or other entities.</td>
</tr>
<tr>
<td><strong>Loan Syndication</strong></td>
</tr>
<tr>
<td>A transaction in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. It is common for groups of lenders to jointly fund those loans when the amount borrowed is greater than any one lender is willing to lend.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-1 Based on the definition of a loan participation, for purposes of applying the guidance in this Subtopic, the debt instrument would be the contract between the debtor and the lead bank. Participating banks are not direct creditors but, rather, have an interest represented by a certificate of participation. In the event of a modification or exchange between the debtor and lead bank, the debtor shall apply the guidance in this Subtopic.</td>
</tr>
<tr>
<td>55-2 Based on the definition of a loan syndication, for purposes of applying the guidance in this Subtopic, separate debt instruments exist between the debtor and the individual creditors participating in the syndication. If an exchange or modification offer is made to all members of the syndicate and only some of the creditors agree to the exchange or modification, the guidance in this Subtopic would be applied to debt instruments held by those creditors that agree to the exchange or modification. Debt instruments held by those creditors that do not agree would not be affected.</td>
</tr>
</tbody>
</table>
Loan participations and loan syndications both involve more than one lender. Legally, however, they are structured differently and therefore ASC 470-50 does not treat them the same.

- In a *loan participation*, the debtor legally has only one loan. That loan is subdivided by a lead lender into multiple undivided interests, which are transferred by the lead lender to individual lenders. Since the arrangement contractually is structured as only one loan, there is only one creditor under ASC 470-50. Therefore, the debtor performs the analysis under ASC 470-50 for the debt arrangement as a whole (i.e., it represents only one unit of account under ASC 470-50) even if new lenders join or existing lenders leave.

- In a *loan syndication*, the debtor legally has separate loans from each member of the syndicate and each lender has a contractual right to payments from the debtor. Therefore, ASC 470-50 treats this arrangement as having multiple creditors (i.e., a separate unit of account for each lender in the syndicate). If the terms of some or all of the syndicated loans are modified, the debtor must perform separate analyses under ASC 470-50 for each member in the syndicate. If a new lender joins the syndicate and extends amounts to the debtor, the debtor treats those amounts as new debt. If the debtor pays off the debt outstanding to an existing member of the syndicate, that debt is accounted for as being extinguished (see Section 9.3). If one loan is modified, but the loans with other members in the loan syndication are not modified, ASC 470-50 is applied only to the loan that was modified.

Often a member of a loan syndication (e.g., an investment bank) provides services that are not directly attributable to its role as a lender in the syndication. For example, that member might arrange the overall set-up of a loan syndication and any modifications to the terms of each of the syndicated loans. Because the accounting for lender fees and third-party costs are different under ASC 470-50, the debtor may need to allocate any fees paid to that member between fees that are appropriately characterized as creditor fees and costs for services that are not attributable to that member’s role as a creditor (see Section 10.3.3.2.4).

### 10.3.3 The 10 Percent Cash Flow Test

#### 10.3.3.1 Background

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>40-10 From the debtor's perspective, an exchange of debt instruments between or a modification of a debt instrument by a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are substantially different if 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. . . .</td>
</tr>
</tbody>
</table>

One circumstance in which the terms of two debt instruments are considered substantially different under ASC 470-50 is when such terms pass the 10 percent cash flow test. The 10 percent cash flow test involves a comparison of the following two amounts: (1) the present value of the cash flows under the terms of the modified or new debt instrument and (2) the present value of the remaining cash flows under the terms of the original instrument.¹ To perform this test, the debtor must determine the timing and amount of the future cash flows of both the original debt and the new debt (Section 10.3.3.2) as well as the interest rate that should be used to discount those cash flows (see Section 10.3.3.3). Special considerations are necessary if an entity has made consecutive modifications or exchanges within a 12-month period (Section 10.3.3.4). A modification or exchange of a debt instrument passes the 10

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¹ In the absence of unamortized debt issuance costs (see Section 10.3.3.3) or fair value hedge accounting adjustments (see Section 10.3.3.4), this amount equals the carrying amount of the original debt.
percent cash flow test if the present value of the new cash flows is at least 10 percent different from the present value of the remaining original cash flows.

An exchange or modification of nontroubled debt that passes the 10 percent cash flow test is accounted for as an extinguishment (see Section 10.4.2). If the 10 percent cash flow test is not passed, the debtor should consider the guidance on embedded conversion features (see Section 10.3.4) before determining whether extinguishment accounting applies.

### 10.3.3.2 Cash Flows

#### 10.3.3.2.1 Background

ASC 470-50 contains guidance on how a debtor should determine the cash flows of the original and new or modified debt, including:

- The cash flows of the new debt instrument (see Section 10.3.3.2.2 below).
- The exercise of contractual provisions in connection with a modification or exchange (see Section 10.3.3.2.3).
- The treatment of creditor fees and third-party costs (see Section 10.3.3.2.4).
- The calculation of the cash flows on variable-rate debt (see Section 10.3.3.2.5).
- The cash flow assumptions when debt contains an embedded put or call option (see Section 10.3.3.2.6).
- The cash flow assumptions for debt with contingent payment features or unusual payment terms (see Section 10.3.3.2.7).
- The treatment of sweeteners and other noncash consideration (see Section 10.3.3.2.8).
- Changes to debt terms that do not directly affect the cash flows (see Section 10.3.3.2.9).
- A change in the currency in which the cash flows are denominated (see Section 10.3.3.2.10).
- The treatment of conversion features (see Section 10.3.3.2.11).

#### 10.3.3.2.2 Cash Flows of New Debt

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<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-12</strong> The following guidance shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test described in paragraph 470-50-40-10:</td>
</tr>
<tr>
<td>a. The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification. . . .</td>
</tr>
</tbody>
</table>

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ASC 470-50-40-12(a) requires a debtor to include all contractual cash flows of the new debt instrument (e.g., future principal and interest payments) as well as any amounts exchanged between the debtor and the creditor as part of the modification or exchange (e.g., amounts identified as fees, principal repayments, and additional borrowings) in the calculation of the present value of the cash flows of the new debt instrument. Any costs paid to third parties, however, are excluded from this calculation (see Section 10.3.3.2.4). Special considerations are necessary if the debtor and creditor exchange amounts in accordance with the contractual provisions of the original debt in conjunction with a debt modification or exchange (see Section 10.3.3.2.3). The debt's fair value is not relevant to whether the 10 percent
cash flow test is passed. However, the fair value of any embedded conversion feature or noncash consideration exchanged should be considered (see Sections 10.3.3.2.8 and 10.3.4).

If a debtor receives cash from a creditor as part of a modification or exchange (e.g., to increase the debt's principal amount), the amount received is treated as an immediate (“day 1”) cash inflow associated with the new debt (i.e., this amount does not need to be discounted). Conversely, if the debtor pays cash to the creditor (e.g., to reduce the debt's principal amount), the amount paid is treated as an immediate cash outflow associated with the new debt.

Because the calculation of the present value of the cash flows of the new debt includes all cash flows of the new instrument and any amounts exchanged as result of the modification or exchange, a debtor cannot, when performing the 10 percent cash flow test, treat any increase or decrease in the principal amount as new borrowings or as extinguishment of a portion of the original debt that is separate from the modification or exchange. Instead, those cash flows are included in the 10 percent cash flow test. This means that a principal payment or an additional borrowing in excess of 10 percent of the present value of the debt's carrying amount immediately before a modification or exchange would not necessarily cause the 10 percent cash flow test to be passed. The calculation of the present value of the cash flows of the new debt must also take into account the change in the remaining future principal and interest cash flows on a present value basis.

Example 10-3

**Modification of Debt That Includes a Partial Repayment**

As part of a debt modification, a debtor agrees to immediately repay $500,000 of the debt's principal amount. This cash outflow would be treated as an undiscounted increase in the present value of the cash flows of the new debt instrument. The debtor would reflect the corresponding reduction in future interest payments and the principal amount repayable at maturity in the present value of the cash flows of the new debt instrument on a discounted basis.

Similarly, if, as part of a modification, the debtor receives additional cash of $300,000 from the creditor, that cash inflow would be included as an undiscounted decrease in the present value of the total cash outflows of the new debt instrument. The debtor would reflect the corresponding increase in future interest payments and the principal amount repayable at maturity in the present value of the cash flows of the new debt instrument on a discounted basis.

**Connecting the Dots**

A debtor may repay a portion of the outstanding principal amount of a debt instrument in conjunction with a modification or exchange that is not accounted for as an extinguishment. Although the debtor does not consider the entire original debt instrument extinguished for accounting purposes, it must still recognize the principal repayment as a partial extinguishment of the original debt instrument. That is, the debtor first considers the principal repayment as an undiscounted increase in the present value of the cash flows of the new debt instrument to determine whether the original debt instrument should be considered extinguished in its entirety as a result of the modification or exchange. If extinguishment accounting is not required for the original debt instrument, the debtor still appropriately accounts for the partial repayment of the original debt instrument. The accounting for such partial repayment should include the derecognition of a proportionate amount of any remaining unamortized debt premiums or discounts (including debt issuance costs) to reflect the fact that a portion of the original debt instrument has been repaid (see Section 10.4.3.2).
10.3.3.2.3 Exercise of Contractual Provisions in Connection With a Modification or Exchange

Although prespecified changes to the cash flows of a debt instrument that result from existing contractual terms (e.g., a partial prepayment of the principal amount pursuant to a contractual prepayment feature) are not debt modifications (see Section 10.2.7), special considerations are necessary if a debtor or creditor exercises a contractual provision in the original debt in conjunction with a modification or exchange.

If a transaction occurs that involves both the exercise of a contractual feature in the original debt and a modification to the debt terms, the debtor's or creditor's decision to exercise the contractual feature may be influenced by the modification of the other contractual terms. If the interest rate on the debt is below current market rates, for example, the debtor might agree to exercise a contractual prepayment feature that is out-of-the-money in exchange for a reduction in the interest rate on the remaining debt balance. Therefore, it is typically appropriate to treat all cash flows exchanged between the debtor and the creditor, including cash flows associated with the exercise of a contractual feature in the original debt in conjunction with a debt modification or exchange, as being part of the debt modification or exchange under ASC 470-50-40-12(a). In this circumstance, a partial prepayment is treated as an immediate cash outflow associated with the new debt under the 10 percent cash flow test (see Section 10.3.3.2.2).

10.3.3.2.4 Fees and Costs

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-4</strong> When debtors undergo a modification or exchange of a debt instrument, the resulting cash flows can be affected by changes in principal amounts, interest rates, or maturity. They can also be affected by fees exchanged between the debtor and creditor to effect changes in any of the following:</td>
</tr>
<tr>
<td>a. Recourse or nonrecourse features</td>
</tr>
<tr>
<td>b. Priority of the obligation</td>
</tr>
<tr>
<td>c. Collateralized (including changes in collateral) or noncollateralized features</td>
</tr>
<tr>
<td>d. Debt covenants or waivers</td>
</tr>
<tr>
<td>e. The guarantor (or elimination of the guarantor)</td>
</tr>
<tr>
<td>f. Option features.</td>
</tr>
</tbody>
</table>

Amounts the debtor pays to or receives from the creditor as part of a modification or exchange are included in the cash flows of the new debt instrument as an immediate (day 1) cash flow. This includes any fees exchanged between the debtor and the creditor as part of the modification or exchange, such as fees paid by the debtor to obtain a waiver of a debt covenant, fees paid by a creditor to remove a call option, or fees related to changes in recourse provisions, collateral, or other debt terms. However, under the 10 percent cash flow test, any third-party fees or costs are excluded, such as fees paid to accountants, attorneys, or financial advisers.

If a debtor pays the creditor's advisers on behalf of the creditor for legal, due diligence, or other costs as part of a modification or exchange of debt (e.g., in connection with a covenant waiver; see Section 10.4.4.2), those costs should be treated similarly to fees paid directly to the creditor. For example, if the debtor reimburses the creditor for costs related to a covenant waiver, the debtor should treat those costs as any other fees paid by the debtor to the creditor, regardless of whether the costs are reimbursed to the creditor or paid directly to the creditor's advisers.
In some modifications or exchanges, a counterparty may simultaneously serve as both creditor and underwriter of debt with other creditors. For example, in a loan syndication arrangement, the underwriter may hold a portion of the total loan facility after the syndication. In such circumstances, the debtor may need to allocate amounts paid to the underwriter between fees paid to the underwriter in its capacity as a creditor (for the portion of the debt agreement that the underwriter receives in the syndication) and fees paid to the underwriter in its capacity as a third party underwriting the loan facility with other creditors. Fees paid to the creditor are included in the 10 percent cash flow test, whereas fees paid to third parties, such as attorneys and accountants, are excluded from it.

If a debtor pays a lead creditor an administrative fee as compensation for serving as an administrative agent for multiple creditors in a loan syndication and the creditor does not own a significant portion of the entity's outstanding debt, the administrative fee is considered an amount paid to a third party rather than an amount paid to a creditor. If a creditor serves as an administrative agent and owns a significant portion of the outstanding debt that is being modified or exchanged, the determination of whether the administrative fee represents an amount paid to a third party or an amount paid to the creditor will depend on the particular facts and circumstances. A payment to an entity in its capacity as an administrative agent is considered an amount paid to a third party rather than an amount paid to a creditor even if the administrative agent is also a creditor. Entities should also be mindful that a lead creditor may be receiving fees for performing services other than administrative agent services, so it is important to understand whether the fees need to be allocated between costs attributable to the debt modification or exchange and costs attributable to other services.

### 10.3.3.2.5 Variable-Rate Debt

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-12</strong> The following guidance shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test described in paragraph 470-50-40-10: . . .</td>
</tr>
<tr>
<td>b. If the original debt instrument or the new debt instrument has a floating interest rate, then the variable rate in effect at the date of the exchange or modification shall be used to calculate the cash flows of the variable-rate instrument. . .</td>
</tr>
</tbody>
</table>

If debt has a variable interest rate either before or after a modification or exchange, ASC 470-50 requires the variable rate in effect on the date of the exchange or modification (i.e., the spot interest rate for the applicable interest period) to be used to estimate the future cash flows of the variable-rate instrument. The guidance does not permit a debtor to use a yield curve of forward rates to project future interest payments. **Section 10.3.3.3** discusses the discount rate that should be used in determining the present value of the cash flows of variable-rate debt.

### 10.3.3.2.6 Puttable or Callable Debt

<table>
<thead>
<tr>
<th>ASC 470-50</th>
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<tbody>
<tr>
<td><strong>40-12</strong> The following guidance shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test described in paragraph 470-50-40-10: . . .</td>
</tr>
<tr>
<td>c. If either the new debt instrument or the original debt instrument is callable or puttable, then separate cash flow analyses shall be performed assuming exercise and nonexercise of the call or put. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10 percent threshold is met. . .</td>
</tr>
</tbody>
</table>
If the terms of the original or new debt or both permit the debtor to prepay (call) or the creditor to demand early repayment (put) or both, ASC 470-50 requires the debtor to perform the 10 percent cash flow test in each possible scenario, irrespective of the intentions or expectations of the parties regarding exercise of the options. In one scenario, the test is applied to the cash flows that would exist if no put or call option is exercised. In other scenarios, the test is applied to the cash flows that would result if each option is exercised in a manner consistent with its contractual terms (e.g., if an option can only be exercised on a specified date, the timing of the assumed cash flows would reflect that). The debtor should consider all possible contractual scenarios, including by varying the prepayment date, related penalties or premiums (if any), and other relevant terms.

In determining whether the 10 percent threshold is passed, the debtor should use the cash flow assumptions that generate the smaller (or, if there are more than two scenarios, smallest) change in the present value. If there is at least one scenario in which the present value of cash flows under the new debt instrument is less than 10 percent different from the present value of the remaining cash flows under the original terms, the 10 percent cash flow test is not passed.

If a debtor concludes that the difference in the present value of the cash flows is less than 10 percent in at least one scenario, the debtor is not required to apply the 10 percent cash flow test to the remaining scenarios. If both the original debt and the new debt are immediately prepayable for the same amount and no cash flows were exchanged as part of the modification or exchange, the 10 percent cash flow test would not be passed since the present values would be the same.

An entity should carefully consider the terms of a call or put feature when performing the 10 percent cash flow test. For example, an entity may need to consider the following:

- The specific terms of prepayment provisions under the original debt instrument may differ from those under the new debt instrument. In the calculation of the present value of cash flows, a debtor should use the specific terms of the original prepayment provision to calculate the remaining cash flows under the original debt instrument and use the new prepayment terms for the new debt instrument.
- Debt often has more than one potential prepayment date. The debtor's scenario analysis should take into account the potential cash flows that would result on any potential prepayment date. If a put or call option is only exercisable on a specified date (or dates), the debtor would assume that it is exercised on that date (or those dates).
- Prepayment may be prohibited for a specified period. The 10 percent cash flow test is only applied to prepayment scenarios that could occur in accordance with the debt's contractual terms.
- Prepayment may carry a penalty or premium, and that penalty or premium may change over time. Prepayment penalties or premiums are treated as part of the debt's cash flows in the potential scenarios in which those penalties or premiums would apply.
- Sometimes put or call options are contingent. The debtor should consider the facts and circumstances as of the date of the modification or exchange in evaluating whether the 10 percent cash flow test should take into account scenarios in which a contingent put or call option is exercised (see Section 10.3.3.2.7).

Note that the debtor should not consider (1) the likelihood that a noncontingent option will be exercised or (2) its intent and ability to exercise an option.
Example 10-4

Application of 10 Percent Cash Flow Test

On January 1, 20X0, Company A entered into a 10-year $500,000 senior secured loan agreement with Bank B that requires A to make quarterly principal and interest payments to B. The quarterly compounded contractual interest rate is 10 percent per annum, and the loan matures on January 1, 20Y0. Company A determines that the effective interest rate equals the contractual interest rate. Under the terms of the loan, A can prepay the loan in full at any time for an amount equal to the unpaid principal and accrued interest on the date of prepayment without any penalty. On July 1, 20X5, A and B agree to amend the loan agreement to ease certain financial covenants. In return, A agrees to an increase in the contractual interest rate to 15 percent, which reflects changes in market rates and the modified covenants. Company A determines that the modification is not a TDR (see Chapter 11). After the modification, A can still prepay the loan at any time with no penalty.

In applying the 10 percent cash flow test to the loan modification, A calculates the following amounts:

- The present value of remaining cash flows under the original terms, assuming (1) exercise of the prepayment option and (2) nonexercise of the prepayment option.
- The present value of the cash flows under the terms of the modified debt instrument, assuming (1) exercise of the prepayment option and (2) nonexercise of the prepayment option.

Because prepayment can occur at any time without a penalty, A assumes in the present value calculations that the prepayment occurs on the earliest possible date (i.e., immediately after the modification). On July 1, 20X5, the unpaid principal amount of the original debt instrument is $285,892. Company A performs the following steps as part of the 10 percent cash flow test:

1. Determine the present value of the cash flows of the original debt instrument:
   a. Assuming exercise of the prepayment option on July 1, 20X5, which results in a present value of remaining cash flows equal to an outflow of $285,892 (unpaid principal with no accrued interest).
   b. Assuming nonexercise of the prepayment option:
      i. Company A makes quarterly payments of $19,918 through January 1, 20Y0, on the basis of the original terms ($500,000 loan, maturing on January 1, 20Y0, with quarterly payments of principal and interest at 10 percent).
      ii. The discount rate is the effective interest rate, for accounting purposes, of the original debt instrument (i.e., 10 percent).
      iii. Accordingly, the present value of the cash flows of the original debt instrument is $285,892.

2. Determine the present value of the cash flows of the modified debt instrument:
   a. Assuming exercise of the prepayment option on July 1, 20X5, which also results in a present value of $285,892.
   b. Assuming nonexercise of the prepayment option:
      i. Company A makes quarterly payments of $22,127 through maturity on January 1, 20Y0, calculated by using the contractual interest rate on the modified debt instrument of 15 percent and face amount of $285,892.
      ii. The discount rate is the effective interest rate, for accounting purposes, of the original debt instrument (i.e., 10 percent).
      iii. The present value of the interest and principal payments on the modified debt instrument at 10 percent is $317,598.

3. Determine the percentage of change in the present value of the debt:
   a. Assuming exercise of the prepayment option for both the original and modified debt instrument, for which the percentage change in present value is 0 percent.
   b. Assuming nonexercise of the prepayment option for the original debt instrument but exercise of the prepayment option for the modified debt instrument, for which the percentage change in present value is 0 percent.
   c. Assuming exercise of the prepayment option for the original debt instrument but nonexercise on the modified debt instrument, for which the percentage change in present value is 11.1 percent.
Example 10-4 (continued)

d. Assuming nonexercise of the prepayment option on both the original and modified debt instrument, for which the percentage change in present value is 11.1 percent.

In A’s calculation, the present value of the cash flows under the modified terms is not substantially different from the present value of the remaining cash flows under the original terms when prepayment is assumed for both the original and modified loan at the earliest possible time or when prepayment is assumed on the modified loan, but not the original loan. If no prepayment is assumed for the original loan and the modified loan, or when prepayment is assumed only for the original loan, the present value of the cash flows is substantially different. Because a debtor uses the cash flow assumptions that generate the smallest change to determine whether the 10 percent threshold is passed, A concludes that the 10 percent cash flow test in ASC 470-50 is not passed. Therefore, if neither the original nor the modified debt contains a conversion feature that meets the conditions in Section 10.3.4.2 or 10.3.4.3, the terms of the modified debt are not considered substantially different from the terms of the original debt and the accounting treatment in Section 10.4.3 applies.

10.3.3.2.7 Contingent or Unusual Payment Terms

ASC 470-50

40-12 The following guidance shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test described in paragraph 470-50-40-10: . . .

d. If the debt instruments contain contingent payment terms or unusual interest rate terms, judgment shall be used to determine the appropriate cash flows. . . .

If debt has contingent payment terms or unusual interest rate features before or after a modification or exchange, the debtor should consider the facts and circumstances and use judgment to estimate the cash flows of the instrument that has those terms. If debt contains a contingently exercisable put or call option, the debtor should include a separate cash flow scenario in which it is assumed that the option is exercised as of the date (or dates) that it is contractually permitted to be exercised if either (1) the contingency is met as of the date of the modification or exchange or (2) it is probable that the contingency will be met. If the likelihood that the contingency will be met is remote, it should not be assumed under the 10 percent cash flow test that the put or call option was exercised.

10.3.3.2.8 Sweeteners and Other Noncash Consideration Exchanged

ASC 470-60

55-12 When determining the effect of any new or revised sweeteners (options, warrants, guarantees, letters of credit, and so forth), the current fair value of the new sweetener or change in fair value of the revised sweetener would be included in day-one cash flows. If such sweeteners are not exercisable for a period of time, that delay is typically considered within the estimation of the initial fair value as of the debt’s modification date.

Sometimes, a debt modification or exchange involves the transfer of noncash consideration, such as the receipt, delivery, or modification of freestanding financial instruments (e.g., warrants, options, or equity shares), between the debtor and creditor. When performing the 10 percent cash flow test, the debtor should treat the fair value of such noncash consideration as an amount paid or received under ASC 470-50-40-12(a); that is, as a day 1 cash flow. This is analogous to a debtor’s requirement to treat the current fair value of any new sweetener (e.g., warrants, options, guarantees, or letters of credit) as an immediate day 1 cash flow in determining whether a creditor has granted a concession under ASC 470-60-55-10 and ASC 470-60-55-12 (see Section 11.3.3.4). However, any noncash consideration paid to
third parties (e.g., attorneys, accountants, or financial advisers) should not be reflected in the 10 percent cash flow test (see Section 10.3.3.2.4).

**Example 10-5**

**Warrants Issued in Exchange for Maturity Extension**

An entity issues warrants to its creditors in exchange for an extension of the maturity date of a debt obligation. The warrants are considered an amount paid to the creditors as part of the modification; therefore, the entity should include their fair value when performing the 10 percent cash flow test under ASC 470-50-40-12(a). Irrespective of whether extinguishment or modification accounting applies, the warrants are recorded initially at fair value with a credit to equity (APIC) or liabilities depending on how they are classified (see Deloitte's *A Roadmap to Distinguishing Liabilities From Equity* and *A Roadmap to Accounting for Contracts on an Entity's Own Equity*).

ASC 470-50 does not address how the addition, removal, or modification of an embedded derivative that has been separated from a debt instrument under ASC 815-15 should be reflected in the 10 percent cash flow test. The debtor may treat such changes as the transfer of noncash consideration (i.e., by imputing an immediate day 1 cash flow for any change in the fair value of the embedded derivative in connection with the modification or exchange). However, the 10 percent cash flow test should not incorporate an imputed cash flow for the change in the fair value of an embedded conversion feature. Instead, conversion features are evaluated separately (see Section 10.3.3.2.11 below).

**10.3.3.2.9 Changes to Debt Terms That Do Not Directly Affect the Cash Flows**

A debt modification may involve changes to contractual terms that do not directly affect the cash flows of the instrument (e.g., seniority in liquidation or collateral). Typically, such changes would not by themselves cause the amended debt terms to be considered substantially different from the original debt terms, except for certain conversion features (see Section 10.3.4).

**10.3.3.2.10 Change in Currency**

The new debt instrument might be denominated in a currency different from that of the original debt instrument (e.g., USD debt that is modified to become GBP debt). If the currency in which a debt instrument’s cash flows is denominated has changed, the debtor needs to convert the cash flows of the original or new debt so that the same currency is used to perform the 10 percent cash flow test. The cash flows should be converted by using an appropriate foreign currency exchange rate. For example, the debtor might convert the cash flows by using the foreign currency spot exchange rate as of the date of the modification or exchange or it might use foreign currency forward exchange rates applicable to each cash flow.

**10.3.3.2.11 Conversion Features**

**ASC 470-50 40-12** The following guidance shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test described in paragraph 470-50-40-10: . . .

  g. The change in the fair value of an embedded conversion option resulting from an exchange of debt instruments or a modification in the terms of an existing debt instrument shall not be included in the 10 percent cash flow test. Rather, a separate test shall be performed by comparing the change in the fair value of the embedded conversion option to the carrying amount of the original debt instrument immediately before the modification, as specified in paragraph 470-50-40-10(a).
When a debtor performs the 10 percent cash flow test, it should not impute any cash flows related
to the modification of an embedded conversion feature or the addition or removal of such a feature.
Instead, it should perform a separate analysis of such changes (see Section 10.3.4). Note, however,
that a conversion feature that in substance represents a share-settled redemption feature should be
analyzed as a put or call option, not as a conversion feature (see Sections 8.4.7.2.5 and 10.3.3.2.6).

10.3.3.3 Discount Rate

10.3.3.3.1 Background

ASC 470-50

| 40-12 | The following guidance shall be used to calculate the present value of the cash flows for purposes of
|       | applying the 10 percent cash flow test described in paragraph 470-50-40-10: . . .
|       | e. The discount rate to be used to calculate the present value of the cash flows is the effective interest rate,
|       | for accounting purposes, of the original debt instrument. . . . |

The discount rate used to calculate the present value of cash flows before and after a modification or
exchange is the effective interest rate of the original debt instrument. In performing the 10 percent cash
flow test, an issuer is not permitted to use different interest rates to discount the cash flows before and
after the modification or exchange. For example, an issuer could not apply the original effective interest
rate to discount the cash flows before a modification of a fixed-rate debt instrument and a current
market rate to discount the cash flows after the modification.

10.3.3.3.2 Variable-Rate Debt

ASC 470-50 does not specifically address how the discount rate should be determined for a variable-rate
instrument (e.g., whether to use a current spot rate or forward rates). Generally, the issuer should
use the effective interest rate immediately before the modification or exchange to discount both the
remaining cash flows of the original debt and the cash flows of the new debt. This is analogous to
the debtor’s requirement in ASC 470-50-40-12(b) to use the variable rate in effect on the date of the
modification or exchange to project the cash flows of a variable-rate instrument when performing the 10
percent cash flow test (see Section 10.3.3.2.5). If the interest rate on the original debt instrument was
fixed and the interest rate on the new debt instrument is variable, the debtor should use the original
effective interest rate to discount both the remaining cash flows of the original debt and the cash flows
of the new debt.

10.3.3.3.3 Debt Issuance Costs

ASC 470-50 does not specifically address whether the discount rate used to perform the 10 percent
cash flow test should reflect the effect of third-party debt issuance costs that were incurred when the
original debt instrument was first issued and deducted from the debt’s initial carrying amount. Third-
party costs do not affect the cash flows between the debtor and the creditor and must be excluded
from the cash flows used to perform the 10 percent cash flow test. Therefore, the discount rate used
in the 10 percent cash flow test should exclude the effect of third-party-debt issuance costs since such
amounts have no bearing on the relationship between the debtor and creditor and the objective of ASC
470-50 is to determine whether a modification or exchange has resulted in a significant change in the
debtor-creditor relationship.
10.3.3.3.4 Fair Value Hedge Adjustments

ASC 470-50 does not specifically address whether the discount rate used to perform the 10 percent cash flow test should reflect the effect of any fair value hedge adjustments that have been made to the debt's carrying amount (see Section 14.2.1.2). Fair value hedging adjustments do not affect the cash flows between the debtor and the creditor. In addition, ASC 470-60-55-11 suggests that hedging effects should not be reflected in the calculation of the effective borrowing rate used to determine whether a debt modification or exchange involves a concession under the TDR guidance in ASC 470-60. Therefore, a debtor should exclude the effect of a fair value hedge adjustment from the discount rate used to perform the 10 percent cash flow test since such amounts have no bearing on the relationship between the debtor and creditor and the objective of ASC 470-50 is to determine whether a modification or exchange has resulted in a significant change in the debtor-creditor relationship.

10.3.3.3.5 Convertible Debt With a Separately Recognized Equity Component

ASC 470-50 does not specifically address how the separation of an equity component under ASC 470-20 affects the discount used to perform the 10 percent cash flow test in ASC 470-50-40-10. It is acceptable to discount the cash flows by using an original effective interest rate that reflects the separation of the CCF or BCF (i.e., the discount rate is the effective interest rate of the original debt instrument after separation of the CCF or BCF; see Sections 7.6.4 and 7.6.5).

10.3.3.4 Consecutive Modifications or Exchanges

<table>
<thead>
<tr>
<th>ASC 470-50</th>
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<tbody>
<tr>
<td>40-12 The following guidance shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test described in paragraph 470-50-40-10: . . .</td>
</tr>
<tr>
<td>f. If within a year of the current transaction the debt has been exchanged or modified without being deemed to be substantially different, then the debt terms that existed a year ago shall be used to determine whether the current exchange or modification is substantially different. . . .</td>
</tr>
</tbody>
</table>

If debt was previously modified or exchanged within one year of the current modification or exchange and the earlier transaction was not accounted for as an extinguishment, the debtor is required to use the debt terms that existed before the earliest modification or exchange within that 12-month period to determine the present value of the remaining cash flows of the original debt instrument. In that case, the cash flows of the new debt instrument would include all cash flows exchanged with the creditor (e.g., modification fees) since the earliest modification or exchange within that 12-month period.

10.3.4 Evaluation of Embedded Conversion Features

10.3.4.1 Background

The terms of the original and new debt instruments are considered substantially different under ASC 470-50 even if the 10 percent cash flow test (see Section 10.3.3) is not passed if either of the following apply:

- The change in the fair value of an embedded conversion option due to a modification or exchange is at least 10 percent of the carrying amount of the original debt instrument immediately before the modification or exchange (see Section 10.3.4.2).
- A substantive conversion option is added to, or eliminated from, the debt terms (see Section 10.3.4.3).
Special considerations are necessary if:

- The embedded conversion feature must be bifurcated as an embedded derivative before or after the modification or exchange or both (see Section 10.3.4.4).
- The convertible debt contains a separately recognized equity component (see Section 10.3.4.5).

### 10.3.4.2 A 10 Percent Change in Embedded Conversion Feature’s Fair Value

<table>
<thead>
<tr>
<th>ASC 470-50</th>
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<tbody>
<tr>
<td><strong>40-10</strong></td>
</tr>
<tr>
<td><strong>a.</strong></td>
</tr>
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</table>

The terms of two debt instruments are considered substantially different under ASC 470-50 if the change in the fair value of an embedded conversion option due to a modification or exchange is at least 10 percent of the carrying amount of the original debt instrument immediately before the modification or exchange. The change in the embedded conversion option's fair value is calculated by comparing its fair value immediately before and after the modification or exchange. A share-settled redemption feature (see Section 8.4.7.2.5) should be evaluated as a put or call option (see Section 10.3.3.2.6) and not as a conversion feature.

#### Example 10-6

**Modification of Conversion Option in Debt**

A long-term debt instrument with a carrying amount of $100 million contains a conversion option that is currently out-of-the-money. The conversion feature is not required to be bifurcated as an embedded derivative under ASC 815-15 and the debt does not contain a separately recognized equity component under ASC 470-20. The debtor and creditor agree to reduce the strike price of the conversion option to increase the likelihood that the creditor will elect to exercise it when the debt matures in a few years. The reduction is not within the scope of the guidance on induced conversions. The fair value of the conversion option immediately before the reduction is $2 million. Immediately after the modification, the fair value is $16 million. Accordingly, the change in the fair value of the conversion feature is $14 million, which exceeds 10 percent of the carrying amount of the original debt instrument immediately before the modification ($14 million + $100 million = 14%). Accordingly, the debt terms are considered substantially different, and extinguishment accounting applies (see Section 10.4.2).

If the change in fair value of an embedded conversion feature is less than 10 percent, the debtor must also consider whether (1) the 10 percent cash flow test is passed (see Section 10.3.3) or (2) a substantive conversion feature was added or removed (see Section 10.3.4.3) before determining whether the debt terms should be considered substantially different under ASC 470-50-40-6 through 40-20.
### 10.3.4.3 Addition or Removal of Substantive Conversion Feature

**ASC 470-50**

| 40-10 | ... If the terms of a debt instrument are changed or modified and the cash flow effect on a present value basis is less than 10 percent, the debt instruments are not considered to be substantially different, except in the following two circumstances: ... |
| b. A 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. (For purposes of evaluating whether an embedded conversion option was substantive on the date it was added to or eliminated from a debt instrument, see paragraphs 470-20-40-7 through 40-9.) |

The terms of two debt instruments are considered substantially different under ASC 470-50 if a substantive conversion option is added to, or eliminated from, a debt instrument. The debtor determines whether the new or eliminated conversion option is substantive as of the date of the modification or exchange. In determining whether a conversion feature is substantive, the debtor applies ASC 470-20-40-7 through 40-9 (see **Section 12.3.3.2**). Under that guidance, a conversion feature is considered substantive if it is at least reasonably possible that it will be exercised in the future. The conversion feature would not be considered substantive 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 modification or exchange date).

A share-settled redemption feature (see **Section 8.4.7.2.5**) should be evaluated as a put or call option (see **Section 10.3.3.2.6**) and not as a conversion feature.

**Example 10-7**

**Modification of Conversion Option in Debt**

A long-term debt instrument with a carrying amount of $100 million contains a conversion option that is currently deep out-of-the-money. The conversion option is not required to be bifurcated as an embedded derivative under ASC 815-15 and the debt does not contain a separately recognized equity component under ASC 470-20. Because it is unlikely that the creditor will elect to exercise the conversion option, the debtor and creditor agree to reduce the strike price of the conversion option to make it at least reasonably possible that the creditor will elect to exercise it in the future. The reduction is not within the scope of the guidance on induced conversions (see **Section 12.3.4**). The conversion option in the original debt instrument is considered nonsubstantive since it was not reasonably possible that the creditor would exercise it. However, the new conversion option is substantive since it is reasonably possible that the creditor will exercise it. Accordingly, the debt terms are considered substantially different, and extinguishment accounting applies (see **Section 10.4.2**).

If no substantive conversion feature was added or removed, the debtor must also consider whether (1) the 10 percent cash flow test is passed (see **Section 10.3.3**) or (2) the change in fair value of an embedded conversion feature is at least 10 percent (see **Section 10.3.4.2**) before determining whether the debt terms should be considered substantially different.
10.3.4.4 Conversion Feature That Is Bifurcated Under ASC 815-15

ASC 470-50 does not specifically address a modification or exchange of debt instruments that affects a conversion feature that has been bifurcated as an embedded derivative. If an embedded conversion feature requires bifurcation as a derivative under ASC 815-15 before and after a modification or exchange, the guidance in ASC 470-50-40-10 does not apply since the conversion feature is accounted for separately from the debt both before and after the modification or exchange. If the conversion feature was not bifurcated as a derivative before the modification or exchange, but requires bifurcation after the modification or exchange, the debtor may analogize to the guidance in ASC 470-50-40-10.

Similarly, if the conversion feature was bifurcated as a derivative before the modification or exchange, but does not require bifurcation after the modification or exchange, the debtor may also analogize to the guidance in ASC 470-50-40-10.

10.3.4.5 Convertible Debt With a Separately Recognized Equity Component

ASC 470-50 does not specifically address how the separation of an equity component under ASC 470-20 (e.g., a BCF or CCF; see Section 7.6) affects an issuer’s assessment of an embedded conversion feature under ASC 470-50-40-10. 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 equity component 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 ASC 470-20 (i.e., it requires the use of a pro forma net carrying amount of the convertible debt instrument as if separation had not occurred).

10.4 Accounting for Debt Modifications and Exchanges

10.4.1 Background

If the terms of a modification or exchange of debt are substantially different, the transaction is accounted for as the extinguishment of the original debt and the recognition of new debt, which is initially measured at its fair value adjusted for certain third-party costs (see Section 10.4.2). If the terms of a modification or exchange of debt are not substantially different, the new debt is accounted for as a continuation of the original debt. Any fees or other amounts exchanged between the debtor and creditor as part of the modification or exchange adjust the debt's carrying amount, whereas any third-party costs are expensed as incurred (see Section 10.4.3). Special considerations are necessary if a debtor incurs costs and fees directly related to a contemplated modification or exchange before the modification or exchange is executed (see Section 10.4.4).
The table below provides an overview of the accounting treatment.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Substantially Different</th>
<th>Not Substantially Different</th>
</tr>
</thead>
<tbody>
<tr>
<td>New or Modified Terms Compared With Original Terms</td>
<td>Any of the following conditions is met:</td>
<td>All of the following conditions are met:</td>
</tr>
<tr>
<td>Substantially Different</td>
<td>• The change in the present value of the cash flows is at least 10 percent (see Section 10.3.3).</td>
<td>• The change in the present value of the cash flows is less than 10 percent (see Section 10.3.3).</td>
</tr>
<tr>
<td></td>
<td>• The change in the fair value of an embedded conversion feature is at least 10 percent of the original carrying amount (see Section 10.3.4.2).</td>
<td>• The change in the fair value of any embedded conversion feature is less than 10 percent of the original carrying amount (see Section 10.3.4.2).</td>
</tr>
<tr>
<td></td>
<td>• A substantive conversion feature is added or removed (see Section 10.3.4.3).</td>
<td>• No substantive conversion feature is added or removed (see Section 10.3.4.3).</td>
</tr>
<tr>
<td>Is a debt extinguishment gain (or loss) recognized?</td>
<td>Yes. Computed as the net carrying amount of the original debt less the fair value of the new debt adjusted for amounts exchanged between the debtor and creditor as part of the modification or exchange.</td>
<td>No. However, if the modification or exchange includes a partial repayment of the original debt instrument, the debtor should account for that prepayment, and a gain or loss may be recognized for the derecognition of a portion of the unamortized premiums or discount (including debt issuance costs) associated with the partial extinguishment (see Section 10.4.3.2).</td>
</tr>
<tr>
<td>Is the debt's net carrying amount adjusted?</td>
<td>Yes. The original debt is derecognized and the new debt is recognized at its fair value less any costs incurred with third parties as part of the modification or exchange.</td>
<td>Yes. The original debt's net carrying amount is increased for any amounts received from the creditor and reduced for (1) any amounts paid to the creditor and (2) any increase in the fair value of an embedded conversion feature.</td>
</tr>
<tr>
<td>Is a new effective interest rate computed?</td>
<td>Yes. Computed on the basis of the new debt's net carrying amount and its future cash flows.</td>
<td>Yes. Computed on the basis of the adjusted net carrying amount of the original debt and the revised cash flows.</td>
</tr>
<tr>
<td>Do fees and other amounts received by the debtor from the creditor as part of the modification or exchange have an immediate impact on earnings?</td>
<td>Yes. They reduce the extinguishment loss or increase the extinguishment gain, as applicable.</td>
<td>No. They increase the debt's net carrying amount and reduce interest expense going forward.</td>
</tr>
<tr>
<td>Do fees and other amounts paid by the debtor to the creditor as part of the modification or exchange have an immediate impact on earnings?</td>
<td>Yes. They increase the extinguishment loss or reduce the extinguishment gain, as applicable.</td>
<td>No. They reduce the debt's net carrying amount and increase interest expense going forward.</td>
</tr>
</tbody>
</table>
New or Modified Terms Compared With Original Terms

<table>
<thead>
<tr>
<th>Substantially Different</th>
<th>Not Substantially Different</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are third-party costs incurred in connection with</td>
<td>No. They reduce the debt's</td>
</tr>
<tr>
<td>the modification or exchange recognized immediately</td>
<td>net carrying amount and</td>
</tr>
<tr>
<td>in earnings?</td>
<td>increase interest expense</td>
</tr>
<tr>
<td></td>
<td>going forward.</td>
</tr>
<tr>
<td>Are any remaining discount or premium and debt</td>
<td>Yes.</td>
</tr>
<tr>
<td>issuance costs associated with the original debt</td>
<td></td>
</tr>
<tr>
<td>recognized immediately in earnings?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>No, unless the modification</td>
</tr>
<tr>
<td></td>
<td>or exchange involves a</td>
</tr>
<tr>
<td></td>
<td>partial principal payment</td>
</tr>
<tr>
<td></td>
<td>by the debtor.</td>
</tr>
</tbody>
</table>

10.4.2 Accounting When Debt Terms Are Substantially Different

10.4.2.1 General

ASC 470-50

40-6 An exchange of debt instruments with substantially different terms is a debt extinguishment and shall be accounted for in accordance with paragraph 405-20-40-1. A debtor could achieve the same economic effect as an exchange of a debt instrument by making a substantial modification of terms of an existing debt instrument. Accordingly, a substantial modification of terms shall be accounted for like an extinguishment.

40-13 If it is determined that the original and new debt instruments are substantially different, the new debt instrument shall be initially recorded at fair value, and that amount shall be used to determine the debt extinguishment gain or loss to be recognized and the effective rate of the new instrument.

40-17 Fees paid by the debtor to the creditor or received by the debtor from the creditor (fees may be received by the debtor from the creditor to cancel a call option held by the debtor or to extend a no-call period) as part of the exchange or modification shall be accounted for as follows:

a. If the exchange or modification is to be accounted for in the same manner as a debt extinguishment and the new debt instrument is initially recorded at fair value, then the fees paid or received shall be associated with the extinguishment of the old debt instrument and included in determining the debt extinguishment gain or loss to be recognized.

40-18 Costs incurred with third parties directly related to the exchange or modification (such as legal fees) shall be accounted for as follows:

a. If the exchange or modification is to be accounted for in the same manner as a debt extinguishment and the new debt instrument is initially recorded at fair value, then the costs shall be associated with the new debt instrument and amortized over the term of the new debt instrument using the interest method in a manner similar to debt issue costs.
When the terms of the new debt are substantially different from those of the original debt (see Section 10.3), the debtor applies extinguishment accounting to the original debt and recognizes the new debt instrument at its fair value less any direct and incremental costs incurred with third parties (i.e., debt issuance costs). The effective interest rate of the new debt is calculated by applying the interest method (see Section 6.2) on the basis of the new debt’s initial net carrying amount and its contractual cash flows.

The calculation of the extinguishment gain or loss recognized in earnings can be summarized as follows:

- The debt’s net carrying amount immediately before the modification or exchange.
- Less:
  - Cash paid by the debtor to the creditor as part of the modification or exchange (e.g., amounts repaid and fees paid).
  - The fair value of any noncash consideration (e.g., warrants or preferred stock) delivered by the debtor to the creditor as part of the modification or exchange.
  - The fair value of the new debt.
- Plus:
  - Cash received by the debtor from the creditor as part of the modification or exchange (e.g., additional amounts borrowed and fees received).
  - The fair value of any noncash consideration received by the debtor from the creditor (e.g., warrants or preferred stock) as part of the modification of exchange.
-Equals extinguishment gain (or loss).

However, special considerations are necessary for transactions involving related parties for which a debt extinguishment gain may be recognized in equity (see Section 9.3.7) and convertible debt that is convertible into the debtor’s equity shares and had a separately recognized equity component (see Section 10.4.2.2).

**Changing Lanes**

In March 2020, the FASB issued ASU 2020-04, which permits debtors not to apply extinguishment accounting to certain debt modifications made in connection with reference rate reform even if ASC 470-50-40 would have required extinguishment accounting (see Section 14.2.5).

---

2 Because the new debt is treated as a new issuance, third-party costs are accounted for as debt issuance costs (see Section 5.3.3). Any fees paid to, or received from, the creditor as part of the modification or exchange are associated with the extinguishment of the original debt and, therefore, affect the calculation of the extinguishment gain or loss. This applies even if some or all of the fees are contractually designated as being attributable to the new debt. As noted in Sections 10.3.2.4 and 10.3.3.2.4, the debtor may need to allocate amounts paid to an underwriter of a loan syndication between fees paid to the underwriter in its capacity as a creditor (for the portion of the debt agreement that the underwriter receives in the syndication) and fees paid to the underwriter in its capacity as a third party underwriting the loan facility with other creditors.
Example 10-8

Modification of Debt — Extinguishment Accounting

On January 1, 20X0, Debtor D issues debt with a stated principal amount of $10 million to Creditor C for proceeds of $9.7 million. Interest is payable annually in arrears at 6 percent. The debt contains no call or put options and matures on January 1, 20X5. Debtor D determines that the annual effective interest rate is 6.73 percent and prepares the following amortization schedule.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Amortization of Discount</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X0</td>
<td>$(9,700,000)</td>
<td>$</td>
<td>$</td>
<td>$9,700,000</td>
</tr>
<tr>
<td>1/1/20X1</td>
<td>$600,000</td>
<td>$652,453</td>
<td>$52,453</td>
<td>$9,752,453</td>
</tr>
<tr>
<td>1/1/20X2</td>
<td>$600,000</td>
<td>$655,981</td>
<td>$55,981</td>
<td>$9,808,434</td>
</tr>
<tr>
<td>1/1/20X3</td>
<td>$600,000</td>
<td>$659,747</td>
<td>$59,747</td>
<td>$9,868,181</td>
</tr>
<tr>
<td>1/1/20X4</td>
<td>$600,000</td>
<td>$663,765</td>
<td>$63,765</td>
<td>$9,931,946</td>
</tr>
<tr>
<td>1/1/20X5</td>
<td>$10,600,000</td>
<td>$668,054</td>
<td>$68,054</td>
<td>$9,999,094</td>
</tr>
</tbody>
</table>

On January 1, 20X3, after D has paid $600,000 of interest for 20X2, D and C agree to modify the debt by extending the term for an additional three years to January 1, 20X8, and increasing the stated interest rate from 6 percent to 8.5 percent per annum. Further, D pays C a fee of $130,000 and incurs $70,000 of third-party costs (e.g., fees to attorneys and accountants).

Debtor D performs the 10 percent cash flow test (see Section 10.3.3). On January 1, 20X3, the present value of the remaining original principal and interest cash flows discounted at 6.73 percent is $9,868,181 and the present value of the remaining modified principal and interest cash flows (including the creditor fee of $130,000 but excluding the third-party costs) discounted at the same discount rate is $10,862,605. The difference in present values is $994,424 ($10,862,605 – $9,868,181), which is more than 10 percent of the present value of the remaining original cash flows ($994,424 ÷ $9,868,181 = 10.1%). Therefore, the terms of the modified debt are considered substantially different from the terms of the original debt.

Because the terms are considered substantially different, extinguishment accounting applies and the new debt is initially recognized at its fair value as of the date of the modification. Debtor D estimates that the fair value of the new debt under ASC 820 is $9,400,000.

Debtor D calculates the extinguishment gain as follows:

\[
\begin{align*}
\text{The debt’s net carrying amount immediately before} & \quad $9,868,181 \\
\text{the modification or exchange} & \\
\text{Cash paid by the debtor to the creditor as part of the} & \quad ($130,000) \\
\text{modification or exchange} & \\
\text{The fair value of the new debt} & \quad ($9,400,000) \\
\text{Extinguishment gain} & \quad $338,181
\end{align*}
\]

Debtor D makes the following accounting entries:

\[
\begin{align*}
\text{Debt (original)} & \quad 9,868,181 \\
\text{Extinguishment gain} & \quad 338,181 \\
\text{Debt (new)} & \quad 9,400,000 \\
\text{Cash} & \quad 130,000
\end{align*}
\]
Example 10-8 (continued)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt (issuance costs)</td>
<td>70,000</td>
</tr>
<tr>
<td>Cash</td>
<td>70,000</td>
</tr>
</tbody>
</table>

Debtor D then calculates the effective interest rate (including the effect of third-party costs) on the new debt and determines that it is 10.28 percent.

### 10.4.2.2 Conversion Features

#### 10.4.2.2.1 Background

There are additional considerations related to convertible debt that is accounted for as extinguished as a result of a modification or exchange.

The debtor should determine the appropriate accounting model to apply to the newly recognized convertible debt instrument that results from a modification or exchange that is accounted for as an extinguishment of the original debt instrument (see Section 7.6). The assumed proceeds for the newly recognized convertible debt instrument are equal to the fair value of the new debt as of the date of the modification or exchange.

#### 10.4.2.2.2 Convertible Debt Without a Separately Recognized Equity Component

If convertible debt without a separately recognized equity component is accounted for as extinguished, the general accounting guidance for extinguishments applies (see Section 10.4.2.1). If the conversion feature in the original debt instrument was bifurcated as a derivative under ASC 815-15, the net carrying amount of the original debt instrument equals the sum of the carrying amount of the host debt contract and the fair value of the embedded conversion option liability as of the date of the extinguishment. The new convertible debt instrument is recognized at fair value less any direct and incremental issuance costs. The debtor should apply the appropriate convertible debt accounting model to the new instrument on the same basis as it would if the entity had issued the instrument in a transaction that did not involve a modification or exchange of the original convertible debt instrument.

#### 10.4.2.2.3 Convertible Debt With a Separately Recognized Equity Component Other Than a BCF or CCF

**ASC 815-15**

40-4 If a convertible debt instrument with a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to the guidance in paragraph 815-15-35-4 is extinguished for cash (or other assets) before its stated maturity date, the entity shall do both of the following:

a. The portion of the reacquisition price equal to the fair value of the conversion option at the date of the extinguishment shall be allocated to equity.

b. The remaining reacquisition price shall be allocated to the extinguishment of the debt to determine the amount of gain or loss.

If the original debt contains an equity component that resulted from the reclassification of an embedded conversion feature from a derivative liability to equity (see Section 8.5.4.3), the calculation of the extinguishment gain or loss should be adjusted by allocating an amount to the reacquisition of the equity component.
equity component equal to the fair value of the conversion option on the date of the extinguishment in accordance with ASC 815-15-40-4 (i.e., the fair value of the conversion option increases the amount of any extinguishment gain and decreases the amount of any extinguishment loss, as applicable). The Codification does not specifically address how to measure the amount that should be allocated to the reacquisition of an equity component that resulted from a previous modification or exchange that increased the fair value of the conversion feature (see Section 10.4.3.3.1) or the issuance of convertible debt at a substantial premium to par (see Section 7.6.3). Generally, the amount that was previously recognized for that equity component would be allocated to its reacquisition.

10.4.2.2.4 Convertible Debt Within the Scope of the Cash Conversion Guidance in ASC 470-20

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-24</strong></td>
</tr>
<tr>
<td><strong>40-25</strong></td>
</tr>
</tbody>
</table>

If a modification or an exchange of an instrument subject to the CCF guidance in ASC 470-20 (see Section 7.6.4) is accounted for as an extinguishment, the issuer applies the derecognition guidance described in Section 9.3.5.4. Under that guidance, the fair value of the consideration transferred is allocated upon derecognition between the liability and equity components of the original 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. That is, the issuer performs the following steps:

1. Determine the fair value of the consideration transferred upon derecognition. This amount includes (a) the fair value of the new convertible debt instrument that results from the modification or 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 modification or exchange 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. Allocate 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 modification or exchange. 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. Treat the new debt instrument that results from the modification or exchange as a newly recognized instrument under GAAP and initially record it at fair value (ASC 470-50-40-13). If the new convertible debt 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), treat 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, these transaction costs are allocated to the liability and equity components of the new convertible debt instrument in proportion to the “proceeds” (i.e., fair value) allocated to it.

If the original convertible debt instrument was not within the scope of the CCF guidance, but the new convertible debt instrument in a modification or exchange that is accounted for as an extinguishment is within the scope of the CCF guidance, the amount allocated between the liability and equity components of the new convertible debt instrument is based on the fair value of the new convertible debt instrument on the extinguishment date (i.e., the amount allocated is not based on the stated principal amount of the original or new convertible debt instrument, the original cash proceeds, or the carrying amount of the original debt instrument before the modification or exchange). The difference between the fair value of the new convertible debt instrument and the fair value of the liability component is allocated to the equity component (see ASC 470-20-30-28) and third party costs that are direct and incremental are allocated to the liability and equity components in the same proportion as the allocation of the fair value of the new convertible debt instrument.

10.4.2.2.5 Convertible Debt With a Separately Recognized BCF

If a modification or exchange of a convertible debt instrument with a separately recognized BCF is accounted for as an extinguishment, 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 calculated. The amount allocated to the BCF equals the intrinsic value of the conversion feature on the extinguishment date (see Section 9.3.5.5). The new convertible debt instrument is treated as if it was a newly issued debt instrument on the basis of its terms, with assumed proceeds equal to the fair value of the new convertible debt instrument as of the extinguishment date. The new convertible debt instrument may contain a BCF, or may require bifurcation of the embedded conversion feature, depending on the circumstances.

10.4.3 Accounting When Debt Terms Are Not Substantially Different

10.4.3.1 General

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-3</strong> In circumstances where an exchange of debt instruments or a modification of a debt instrument does not result in extinguishment accounting, this Subtopic provides guidance on the appropriate accounting treatment.</td>
</tr>
<tr>
<td><strong>40-14</strong> If it is determined that the original and new debt instruments are not substantially different, then a new effective interest rate shall be determined based on the carrying amount of the original debt instrument, adjusted for an increase (but not a decrease) in the fair value of an embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) resulting from the modification, and the revised cash flows.</td>
</tr>
</tbody>
</table>
ASC 470-50 (continued)

40-17 Fees paid by the debtor to the creditor or received by the debtor from the creditor (fees may be received by the debtor from the creditor to cancel a call option held by the debtor or to extend a no-call period) as part of the exchange or modification shall be accounted for as follows: . . .

b. If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the fees shall be associated with the replacement or modified debt instrument and, along with any existing unamortized premium or discount, amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the interest method.

40-18 Costs incurred with third parties directly related to the exchange or modification (such as legal fees) shall be accounted for as follows: . . .

b. If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the costs shall be expensed as incurred.

When the terms of the new debt are not substantially different from those of the original debt (see Section 10.3), the modification or exchange is treated as a continuation of the original debt instrument. The debtor adjusts the debt’s net carrying amount, as follows:

- The debt’s net carrying amount immediately before the modification or exchange.

- Less:
  - Cash paid by the debtor to the creditor as part of the modification or exchange (e.g., amounts repaid and fees paid).³
  - The fair value of any noncash consideration (e.g., warrants or preferred stock) delivered by the debtor to the creditor as part of the modification or exchange.
  - The increase in the fair value of an embedded equity conversion feature, if applicable (see Section 10.4.3.3).

- Plus:
  - Cash received by the debtor from the creditor as part of the modification or exchange (e.g., additional amounts borrowed and fees received).
  - The fair value of any noncash consideration received by the debtor from the creditor (e.g., warrants) as part of the modification of exchange.

- Equals the debt’s adjusted net carrying amount.

ASC 470-50-40-17(b) requires any fees paid to, or received from, the creditor as part of a modification or exchange (e.g., waiver fees) to be associated with the modified debt and recognized as part of interest expense over the life of the modified debt in accordance with the interest method.

Because the debt is accounted for as a continuation of the original debt, any third-party costs incurred in connection with the modification or exchange do not represent debt issuance costs (see Chapter 5). ASC 470-50-40-17(b) requires such costs to be immediately expensed as incurred.

As noted in Sections 10.3.2.4 and 10.3.3.2.4, the debtor may need to allocate amounts paid to an underwriter of a loan syndication between fees paid to the underwriter in its capacity as a creditor (for the portion of the debt agreement that the underwriter receives in the syndication) and fees paid to the underwriter in its capacity as a third party underwriting the loan facility with other creditors. Amounts

³ See Sections 10.3.3.2 and 10.4.3.2 for discussions of the accounting for any unamortized premiums, discounts, or issue costs associated with the partial repayment of the existing debt instrument.
paid to the underwriter in its capacity as a creditor are treated as lender fees, whereas amounts paid to
the underwriter in its capacity as an underwriter are treated as third-party costs.

The effect of the debt modification or exchange on the debt's cash flows are accounted for prospectively
as a yield adjustment. Although the debt is not accounted for as extinguished, the debtor must
recalculate the effective interest rate it used in applying the interest method (see Section 6.2) since the
net carrying amount and the debt's contractual cash flows have changed.

### Example 10-9

**Modification of Debt — Modification Accounting**

On January 1, 20X0, Debtor E issues debt with a stated principal amount of $10 million to Creditor B for
proceeds of $10.4 million. Interest is payable annually in arrears at 9 percent. There are no call options, put
options, or conversion features in the debt, which matures on January 1, 20X5. Debtor E determines that the
annual effective interest rate is 8 percent and prepares the following amortization schedule.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Amortization of Premium</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X0</td>
<td>(10,400,000)</td>
<td>—</td>
<td>—</td>
<td>10,400,000</td>
</tr>
<tr>
<td>1/1/20X1</td>
<td>900,000</td>
<td>831,815</td>
<td>68,185</td>
<td>10,331,815</td>
</tr>
<tr>
<td>1/1/20X2</td>
<td>900,000</td>
<td>826,361</td>
<td>73,639</td>
<td>10,258,176</td>
</tr>
<tr>
<td>1/1/20X3</td>
<td>900,000</td>
<td>820,472</td>
<td>79,528</td>
<td>10,178,648</td>
</tr>
<tr>
<td>1/1/20X4</td>
<td>900,000</td>
<td>814,111</td>
<td>85,889</td>
<td>10,092,759</td>
</tr>
<tr>
<td>1/1/20X5</td>
<td>10,900,000</td>
<td>807,241</td>
<td>92,759</td>
<td>—</td>
</tr>
</tbody>
</table>

On January 1, 20X3, after E has paid $900,000 of interest for 20X2, E and B agree to modify the debt by
extending the term for an additional three years to January 1, 20X8, and reducing the stated interest rate from
9 percent to 7.5 percent per annum. Further, E pays B a fee of $50,000 and incurs $85,000 of third-party costs
(e.g., fees to attorneys and accountants).

Debtor E performs the 10 percent cash flow test (see Section 10.3.3). On January 1, 20X3, the present value of
the remaining original principal and interest cash flows discounted at 8 percent is $10,178,648, and the present
value of the remaining modified principal and interest cash flows (including the creditor fee of $50,000 but
excluding the third-party costs) discounted at the same discount rate is $9,801,065. The difference in present
values is $377,583 ($10,178,648 – $9,801,065), which is less than 10 percent of the present value of the
remaining original cash flows ($377,583 ÷ $10,178,648 = 3.7%). Therefore, the terms of the modified debt are
not considered substantially different from the terms of the original debt under the 10 percent cash flow test.
Further, neither the original debt nor the modified debt is convertible into the debtor's equity shares, so there
is no need to evaluate whether any conversion feature causes the modified debt to be substantially different
from the original debt.

Because the terms of the modified debt are not considered substantially different from the terms of the
original debt, the modified debt is treated as a continuation of the original debt. However, E must update the
debt's net carrying amount and amortization schedule and expense the third-party costs incurred as part of its
accounting for the modification or exchange.

The updated carrying amount is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>The debt's net carrying amount immediately before the modification or exchange</td>
<td>$10,178,648</td>
</tr>
<tr>
<td>Cash paid by the debtor to the creditor as part of the modification or exchange</td>
<td>($50,000)</td>
</tr>
<tr>
<td>New carrying amount</td>
<td>$10,128,648</td>
</tr>
</tbody>
</table>
Example 10-9 (continued)

Debtor E makes the following accounting entries:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>50,000</td>
</tr>
<tr>
<td>Expense (third-party costs)</td>
<td>85,000</td>
</tr>
<tr>
<td>Cash</td>
<td>135,000</td>
</tr>
</tbody>
</table>

The revised effective interest rate is 7.18 percent.

10.4.3.2 Exercise of Contractual Provisions in Connection With a Debt Modification or Exchange

ASC 470-50-40-17(b) states that any remaining unamortized premium or discount (including debt issuance costs) of the original debt instrument should be amortized over the remaining term using the interest method when debt is modified or exchanged and extinguishment accounting does not apply. However, if, in conjunction with a modification or exchange that is not an extinguishment, a debtor prepays a portion of principal amount of the original debt instrument, whether pursuant to a contractual prepayment feature or from negotiations between the debtor and creditor, the debtor should derecognize a proportionate amount of unamortized premium or discount (including debt issuance costs) in the same manner as it would if the debt was partially prepaid in the absence of a modification or exchange.\(^4\)

Example 10-10

Modification of Debt — Accounting for Partial Repayment

Entity A has outstanding a debt instrument with a $100 million principal amount and an unamortized discount (including debt issuance costs) of $2.5 million. Interest on the debt is payable annually at a rate of 10 percent. The debt is modified to reduce the interest rate to a market rate of 8 percent and to extend the remaining term by five years. In return for agreeing to the modification, the creditor requires A to repay $20 million of the principal amount without a penalty. In conjunction with the modification, A incurs third-party costs of $200,000. Assume that because the original debt and the modified debt are both prepayable, the modification does not meet the conditions to be accounted for as an extinguishment.

Before accounting for the partial prepayment, A recognizes the following accounting entry:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense (third-party costs)</td>
<td>200,000</td>
</tr>
<tr>
<td>Cash</td>
<td>200,000</td>
</tr>
</tbody>
</table>

To account for the partial prepayment, A recognizes the following additional accounting entry:\(^5\)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>20,000,000</td>
</tr>
<tr>
<td>Loss on partial debt extinguishment</td>
<td>500,000</td>
</tr>
<tr>
<td>Cash</td>
<td>20,000,000</td>
</tr>
<tr>
<td>Unamortized discount (issuance costs)</td>
<td>500,000</td>
</tr>
</tbody>
</table>

Note that this additional entry is necessary because A’s application of ASC 470-50 does not obviate its need to apply the general debt accounting guidance when it partially prepays the existing debt in conjunction with the modification.

---

\(^4\) Note that for this purpose, a payment of a fee to the creditor in return for the modification would not need to be treated as a partial prepayment.

\(^5\) The amount of unamortized discount (debt issuance costs) written off is based on the proportion of the principal amount of the debt that was repaid (i.e., $20 million / $100 million = 0.2 \times 2.5 million = $500,000).
10.4.3.3 Conversion Features

10.4.3.3.1 General

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>40-15 If a convertible debt instrument is modified or exchanged in a transaction that is not accounted for as an extinguishment, an increase in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) shall reduce the carrying amount of the debt instrument (increasing a debt discount or reducing a debt premium) with a corresponding increase in additional paid-in capital. However, a decrease in the fair value of an embedded conversion option resulting from a modification or an exchange shall not be recognized.</td>
</tr>
</tbody>
</table>

When modified or exchanged debt is convertible into the debtor's equity shares before and after a modification or exchange and extinguishment accounting does not apply (see Section 10.3), the debtor is required to recognize an increase, if any, in the fair value of the embedded conversion feature that results from the modification or exchange. Such increase is calculated as the amount by which the fair value of the conversion option immediately after the modification or exchange exceeds its fair value immediately before the modification and exchange. This amount is recognized as a decrease in the net carrying amount of the debt and an increase in APIC. Because the amount recorded against the debt increases any debt discount (or reduces a debt premium), whereas the amount in APIC is not remeasured, the effect of this accounting is to increase the debt's effective interest rate and the amount of interest expense reported over the debt's remaining life. A decrease in the conversion feature's fair value is not recognized.

Special considerations are necessary if the convertible debt is subject to the guidance on CCFs (see Section 10.4.3.3.3) or BCFs (see Section 10.4.3.3.4) or the conversion feature is bifurcated as a derivative under ASC 815-15 (see Section 10.4.3.3.2 below).

10.4.3.3.2 Convertible Debt With a Bifurcated Conversion Option

<table>
<thead>
<tr>
<th>ASC 815-15</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-4 If an embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in this Subtopic, an issuer shall account for the previously bifurcated conversion option by reclassifying the carrying amount of the liability for the conversion option (that is, its fair value on the date of reclassification) to shareholders' equity. Any debt discount recognized when the conversion option was bifurcated from the convertible debt instrument shall continue to be amortized.</td>
</tr>
</tbody>
</table>

The Codification does not specifically address how to account for a change in the fair value of a conversion feature that is bifurcated as a derivative under ASC 815-15 either before or after a modification or exchange.

If the conversion feature is bifurcated as a derivative under ASC 815-15 before and after the modification or exchange, any change in its fair value is recognized in earnings under ASC 815-15. Therefore, the debtor should not apply the guidance in ASC 470-50-40-15 on recognizing an increase in a feature's fair value in connection with the modification or exchange as a reduction of the debt's carrying amount (see Section 10.4.3.3.1 above).

If the conversion feature is bifurcated as a derivative under ASC 815-15 before the modification or exchange, but not after the modification or exchange, one possible approach would be for the debtor to reclassify the fair value carrying amount of the derivative liability immediately after the modification.
or exchange to equity under ASC 815-15-35-4 and not apply the guidance in ASC 470-50-40-15 (see Section 10.4.3.3.1).

If the conversion feature is bifurcated as a derivative under ASC 815-15 after the modification or exchange, but not before the modification or exchange, one possible approach would be for the debtor to recognize an increase in the fair value of the embedded conversion feature in connection with the modification or exchange as a reduction in the debt's net carrying amount, with an offset to APIC under ASC 470-50-40-15 (see Section 10.4.3.3.1). The fair value of the conversion feature immediately after the modification or exchange would then be bifurcated from the carrying amount of the debt host (see Section 8.5.4.2).

10.4.3.3.3 Convertible Debt Within the Scope of the CCF Guidance in ASC 470-20

If a modification (or exchange) does not result in derecognition of the original instrument, then the expected life of the liability component shall be reassessed based on the guidance in paragraph 470-20-35-15 and the issuer shall determine a new effective interest rate for the liability component in accordance with the guidance in Subtopic 470-50.

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 shall continue to be accounted for separately unless the original instrument is required to be derecognized under Subtopic 470-50.

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.

If a modification or exchange of a convertible debt instrument subject to the CCF guidance in ASC 470-20 (see Section 7.6.4) is not accounted for as an extinguishment, the issuer should perform the following steps if the convertible debt instrument remains subject to the CCF guidance:

- Reassess the effective life of the instrument under ASC 470-20-35-15 (see Section 6.3.2.4.1 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt for a discussion of how to estimate the expected life).

- If the terms of the embedded conversion option are modified, 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. A decrease in the option's fair value is not recognized.

- Adjust the prospective yield in accordance with ASC 470-20-40-23 and ASC 470-50-40-14 (see Section 10.4.3.1) by updating the effective interest rate of the liability component prospectively on the basis of (1) the liability component's adjusted carrying amount and (2) the modified cash flows.
If an instrument ceases to require or permit cash settlement upon conversion as a result of a modification or exchange that is not accounted for as an extinguishment, the liability and equity components continue to be accounted for separately. Paragraph B17 of FSP APB 14-1 states, in part:

If an instrument within the scope of [the CCF guidance in ASC 470-20] 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 pursuant to the [cash conversion] guidance in [ASC 470-20] unless extinguishment accounting is required under [ASC 470-50]. That guidance is consistent with the EITF's conclusions in Issues 06-6 and 06-7 that [ASC 470-20-25-12] only applies at inception. Therefore, a convertible debt instrument within the scope of [the CCF guidance in ASC 470-20] that is originally separated into liability 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.

If a convertible debt instrument that is outside the scope of the CCF guidance becomes subject to the CCF guidance after a modification or exchange that is not accounted for as an extinguishment, the issuer applies the CCF guidance prospectively. 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.

10.4.3.3.4 Convertible Debt Subject to the BCF Guidance in ASC 470-20

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>40-16 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 modification or exchange of a convertible debt instrument is not accounted for as an extinguishment, the issuer neither recognizes a new BCF nor reassesses an existing BCF (see Section 7.6.5). Instead, the issuer applies the guidance in ASC 470-50-40-15 to account for a change in the fair value of the conversion feature (see Section 10.4.3.3.1).

10.4.4 Other Considerations

10.4.4.1 Costs and Fees Incurred Before a Debt Modification or Exchange

Sometimes, debtors incur fees or costs directly related to a contemplated modification or exchange before it is executed. In a manner similar to the accounting for debt issuance costs incurred before a debt issuance (see Section 5.3.2), specific costs and fees that are directly attributable to a contemplated modification or exchange of debt may be deferred as an asset before such transaction occurs unless (1) it is probable that modification or exchange will not occur or (2) the fees or costs must be expensed under ASC 470-50 upon the occurrence of the transaction. Under ASC 470-50, a fee paid to a creditor (e.g., a waiver fee) must be expensed if the terms of the new debt are substantially different from the terms of the original debt (see Section 10.4.2.1). Third-party costs (e.g., attorney fees) must be expensed if the terms of the new debt are not substantially different from those of the original debt (see Section 10.4.3.1).

Once the modification or exchange occurs, any costs or fees that have been deferred are reflected in the accounting for the modification or exchange under ASC 470-50. If costs and fees have been deferred but it becomes probable that the modification or exchange will not take place or the costs and fees
Chapter 10 — Debt Modifications and Exchanges

would require expense recognition upon a modification or exchange, the amounts deferred should be charged to earnings.

### 10.4.4.2 Third-Party Costs

A third party, such as a legal adviser or investment banker, often provides services related to a debt modification or exchange simultaneously with other unrelated services. Such fees should be allocated between costs attributable to the debt modification or exchange and costs attributable to other services provided by the third party on a relative fair value basis. Under ASC 340-10-S99-2, similar accounting is required for fees paid to an investment banker for both services related to an acquisition and the issuance of debt securities in a business combination (see Section 3.5.3.3).

Costs attributable to the debt modification or exchange may include:

- Amounts paid to legal advisers for drafting modified debt agreements and providing other legal services associated with the debt modification.
- Amounts paid to advisers for assistance with the debt negotiations.

Costs attributable to other services may include:

- Amounts paid to legal advisers for assistance in drafting documents for a bankruptcy filing.
- Amounts paid to legal advisers for providing advice on a corporate restructuring.
- Amounts paid to a communications firm in connection with a corporate restructuring.

Once the entity identifies the costs attributable to the debt modification or exchange, it should account for those costs on the basis of whether the modification or exchange represents an extinguishment of the debt in accordance with ASC 470-50 (see Sections 10.4.2 and 10.4.3).

### 10.5 Modifications and Exchanges Involving Third-Party Intermediaries

#### 10.5.1 Background

Sometimes, debtors involve a third-party intermediary to arrange or facilitate a debt modification or exchange with the entity's creditors. For example, if a debtor wishes to replace existing debt for new debt, it might engage a bank to seek out holders of the existing debt and offer them the new debt. The accounting analysis of a debt modification or exchange that involves an intermediary depends on whether the intermediary is considered a principal to the transaction or the debtor's agent. If the issuer concludes that the intermediary is acting as its agent, ASC 470-50 requires the issuer to “look through” the intermediary by treating the intermediary's actions as its own (i.e., the intermediary's transactions with other parties would be considered the debtor's own transactions). If the issuer determines that the intermediary is acting as a principal, the issuer would not look through the intermediary but would instead view the intermediary as a third-party creditor (i.e., the intermediary's transactions with other parties would be considered transactions among debt holders to which the debtor is not a party; see Section 10.2.8).

Section 10.5.2 addresses how to determine whether an intermediary should be viewed as a principal or an agent under ASC 470-50. Section 10.5.3 discusses the accounting for modifications or exchanges involving an intermediary.
10.5.2 Principal-Versus-Agent Analysis

10.5.2.1 Background

**ASC 470-50**

**55-7** Transactions between a debtor and a third-party creditor should be analyzed based on the guidance in paragraph 405-20-40-1 and the guidance in this Subtopic to determine whether gain or loss recognition is appropriate. Application of the guidance in this Subtopic may require determination of whether a third-party intermediary is an agent or a principal and consideration of legal definitions may be helpful in making that determination. Generally, an agent acts for and on behalf of another party. Therefore, a third-party intermediary is an agent of a debtor if it acts on behalf of the debtor. In addition, an evaluation of the facts and circumstances surrounding the involvement of a third-party intermediary should be performed. . . .

Generally, an intermediary is considered to be the debtor’s agent if it “acts for and on behalf of” the debtor. For example, an intermediary would be viewed as the debtor’s agent if the intermediary’s actions are for the debtor’s benefit and under the debtor’s discretion and control. ASC 470-50-55-7 suggests that in evaluating whether an intermediary is acting as a principal or an agent, a debtor may find it helpful to consider legal definitions. Further, ASC 470-50-55-7 provides a list of indicators that a debtor must evaluate when determining whether a third-party intermediary is acting as a principal or agent:

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Factors Suggesting That Intermediary Is Acting as Principal</th>
<th>Factors Suggesting That Intermediary Is Acting as Debtor’s Agent</th>
<th>Roadmap Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intermediary’s exposure to risk of loss</td>
<td>Places its own funds at risk</td>
<td>Indemnified by the debtor for any losses</td>
<td>10.5.2.2</td>
</tr>
<tr>
<td>Intermediary’s level of commitment</td>
<td>Firmly committed</td>
<td>Best efforts</td>
<td>10.5.2.3</td>
</tr>
<tr>
<td>Debtor’s power to direct the intermediary’s transactions</td>
<td>Intermediary directs transactions and is subject to loss</td>
<td>Debtor directs intermediary's transactions</td>
<td>10.5.2.4</td>
</tr>
<tr>
<td>Intermediary’s compensation</td>
<td>Varies on the basis of debt gains and losses</td>
<td>Preestablished fee</td>
<td>10.5.2.5</td>
</tr>
</tbody>
</table>

10.5.2.2 Intermediary’s Exposure to Risk of Loss

**ASC 470-50**

**55-7**. . . The following indicators should be considered in that evaluation:

- If the intermediary’s role is restricted to placing or reacquiring debt for the debtor without placing its own funds at risk, that would indicate that the intermediary is an agent. For example, that may be the case if the intermediary’s own funds are committed and those funds are not truly at risk because the intermediary is made whole by the debtor (and therefore is indemnified against loss by the debtor). If the intermediary places and reacquires debt for the debtor by committing its funds and is subject to the risk of loss of those funds, that would indicate that the intermediary is acting as principal. . . .

If an intermediary places its own funds at risk (i.e., it is exposed to the risk of changes in the value of the debt), this suggests that the intermediary is acting as a principal in its transactions with the debtor and investors. In this circumstance, the intermediary’s transactions with investors represent transactions among debt holders (see Section 10.2.8), which do not affect the debtor’s accounting. If
the intermediary does not place its own funds at risk, this suggests that the intermediary is acting as the
debtor's agent in its transactions with investors.

The following factors, if present, would suggest that the intermediary is not placing its own funds at risk
and, therefore, is the debtor’s agent:

- The period during which the intermediary holds any new debt it acquires from the debtor before
it resells it to investors is not sufficient to expose it to a significant risk of loss from changes in
the debt’s value.
- The period during which the intermediary holds any outstanding debt it acquires from investors
before it resells it to the debtor is not sufficient to expose it to a significant risk of loss from
changes in the debt’s value.
- The intermediary obtains purchase commitments from investors before buying new debt from
the debtor.
- The intermediary obtains sale commitments from investors before it commits to sell outstanding
debt to the debtor.
- The intermediary obtains soft bids from investors before buying new debt from the debtor (see
also Section 10.5.3.4).
- The debtor reimburses the intermediary for any losses (or hedging costs) it incurs as a result of
changes in the debt’s value in the short period during which it holds debt.

The debtor cannot assume that an intermediary is acting as a principal under ASC 470-50-55-7 even if
the intermediary is firmly committed to purchasing new debt securities from the debtor at a specified
price and the debtor is under no obligation to indemnify the issuer against any loss. Other facts and
circumstances that may affect whether the intermediary’s own funds are at risk must also be considered.
If the intermediary obtains soft bids from investors before it commits to purchasing debt securities from
the debtor, the intermediary’s risk of loss may be reduced to such a degree that the intermediary should
be viewed as the debtor’s agent.

In a speech at the 2003 AICPA Conference on Current SEC Developments, SEC Professional Accounting
Fellow Robert Comerford discussed the application of the indicators in ASC 470-50-55-7 to a modified
remarketable put bond transaction (see Section 10.5.3.4). In Mr. Comerford’s example, the intermediary
(an investment bank) has a call option that permits it to buy the debtor’s debt securities from investors.
If the intermediary calls the debt securities, it will attempt to resell them to new investors at a reset
interest rate. Mr. Comerford suggested that if the intermediary obtains soft bids from prospective
investors before calling the existing debt securities, the intermediary may be acting as the debtor’s agent
in exercising the call option and reselling the modified debt securities to new investors.

Other factors may also affect the analysis, including the debtor’s creditworthiness and the length of
time between the intermediary’s purchase of the debt from the issuer and its sale thereof to investors.
Entities should evaluate all facts and circumstances associated with the transaction when assessing
whether an intermediary is acting as an agent or a principal.
10.5.2.3 **Intermediary's Level of Commitment**

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-7</strong> . . . The following indicators should be considered in that evaluation: . . .</td>
</tr>
<tr>
<td>b. In an arrangement where an intermediary places notes issued by the debtor, if the placement is done under a best-efforts agreement, that would indicate that the intermediary is acting as agent. Under a best-efforts agreement, an agent agrees to buy only those securities that it is able to sell to others; if the agent is unable to remarket the debt, the issuer is obligated to pay off the debt. The intermediary may be acting as principal if the placement is done on a firmly committed basis, which requires the intermediary to hold any debt that it is unable to sell to others. . . .</td>
</tr>
</tbody>
</table>

If an intermediary is firmly committed to executing transactions with the debtor irrespective of whether it is able to arrange offsetting transactions, this suggests that the intermediary is acting as a principal in its transactions with the debtor. For example, the fact that the intermediary is required to hold any new debt that it acquires from the debtor and is unable to sell to other investors suggests that the intermediary is acting as a principal. If the intermediary is required to execute transactions with the debtor only if it is able to arrange offsetting transactions with investors, this indicates that the intermediary is acting as the debtor's agent. For example, the intermediary is likely to be viewed as the debtor's agent if (1) the intermediary is required to purchase debt from the debtor only if it is able to sell it to investors or (2) the debtor is required to repurchase any debt securities it has sold to the intermediary if the intermediary is unable to sell it to investors.

10.5.2.4 **Debtor's Power to Direct the Intermediary's Transactions**

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-7</strong> . . . The following indicators should be considered in that evaluation: . . .</td>
</tr>
<tr>
<td>c. If the debtor directs the intermediary and the intermediary cannot independently initiate an exchange or modification of the debt instrument, that would indicate that the intermediary is an agent. The intermediary may be a principal if it acquires debt from or exchanges debt with another debt holder in the market and is subject to loss as a result of the transaction. . . .</td>
</tr>
</tbody>
</table>

If the debtor directs the specific purchase or sale transactions that the intermediary executes with investors, this suggests that the intermediary is the debtor's agent. If the intermediary makes its own independent decisions regarding whether to execute purchase or sale transactions involving the debt with investors and it is exposed to gains and losses on such transactions, this suggests that the intermediary is a principal.

10.5.2.5 **Intermediary's Compensation**

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-7</strong> . . . The following indicators should be considered in that evaluation: . . .</td>
</tr>
<tr>
<td>d. If the only compensation derived by an intermediary from its arrangement with the debtor is limited to a preestablished fee, that would indicate that the intermediary is an agent. If the intermediary derives gains based on the value of the security issued by the debtor, that would indicate that the intermediary is a principal.</td>
</tr>
</tbody>
</table>
If the debtor has agreed to any of the following fee or other compensation arrangements with the intermediary, this suggests that the intermediary is the debtor’s agent:

- The intermediary’s compensation is limited to a predetermined fee and the intermediary is not exposed to gains or losses from its transactions with investors.
- The intermediary’s compensation includes reimbursement by the debtor of any losses the intermediary incurs as a result of changes in the debt’s value or other hedging costs during the period in which it holds debt.
- The intermediary’s compensation includes a premium to compensate it for potential losses and therefore its own funds are not substantively at risk.

If the intermediary is exposed to fluctuations in the debt’s value during the period in which it holds the debt, this suggests that the intermediary is acting as a principal.

10.5.3 Accounting for Modifications or Exchanges Involving an Intermediary

10.5.3.1 Background

The accounting for a debt modification or exchange involving an intermediary depends on whether the intermediary is acting as a principal (see Section 10.5.3.2 below) or the debtor’s agent (see Section 10.5.3.3). At the 2003 AICPA Conference on Current SEC Developments, the SEC staff highlighted certain considerations related to the principal-agent analysis that apply to soft bids and remarketable put bond transactions (see Section 10.5.3.4).

10.5.3.2 Intermediary Acting as Principal

| ASC 470-50 |
|-----------------|--------------------------------------------------------------------------------------------------|
| 40-20           | In transactions involving a third-party intermediary acting as principal, the intermediary should be viewed as a third-party creditor similar to any other creditor in order to determine whether there has been an exchange of debt instruments or a modification of terms between a debtor and a creditor. Stated another way, if a third-party intermediary acts as principal, the analysis should not look through the intermediary. |
| 55-5            | In transactions involving a third-party investment banker acting as principal, the investment banker is considered a debt holder like other debt holders. Thus, if the investment banker acting as principal acquires debt instruments from other parties, the acquisition by the investment banker does not impact the accounting by the debtor, and exchanges or modifications between the debtor and the investment banker shall follow the guidance in this Subtopic. |

If an intermediary is considered a principal under ASC 470-50, the debtor treats any purchase or sale transactions that it executes with the intermediary as transactions with a creditor. Accordingly:

- The intermediary’s purchases and sales of the debtor’s debt with parties other than the debtor are treated as transactions among holders of the debt (see Section 10.2.8) and, accordingly, do not affect the debtor’s accounting as long as funds do not pass through the debtor.
- The debtor evaluates whether exchanges of its outstanding debt for new debt with the intermediary (including transactions with the intermediary that involve a contemporaneous cash exchange, settlement of the original debt, and issuance of new debt) should be accounted for as an extinguishment or modification under ASC 470-50. The debtor should consider the relevant facts and circumstances to determine whether the settlement of the old debt is contemporaneous with the issuance of any new debt to the intermediary.
• If the intermediary purchases the debtor’s new debt from the debtor for cash and does not contemporaneously settle outstanding debt with the debtor, the debtor treats the sale of new debt to the intermediary as a new debt issuance.

• If the intermediary settles the debtor’s outstanding debt with the debtor for cash and does not contemporaneously purchase new debt from the debtor, the debtor treats the settlement as an extinguishment of the outstanding debt under ASC 405-20-40-1 (see Section 9.2).

### 10.5.3.3 Intermediary Acting as Agent

<table>
<thead>
<tr>
<th>ASC 470-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>40-19 In transactions involving a third-party intermediary acting as agent on behalf of a debtor, the actions of the intermediary shall be viewed as those of the debtor in order to determine whether there has been an exchange of debt instruments or a modification of terms between a debtor and a creditor. Stated another way, if a third-party intermediary acts as agent, the analysis shall look through the intermediary.</td>
</tr>
<tr>
<td>55-4 In transactions involving a third-party investment banker acting as agent on behalf of the debtor, the activity of the investment banker is treated as if it were the activity of the debtor. Thus, if the investment banker acquires debt instruments from holders for cash, the debtor has an extinguishment even if the investment banker subsequently transfers a debt instrument with the same or different terms to the same or different investors. If the investment banker acting as agent on behalf of the debtor acquires instruments from holders by exchanging those instruments for new debt, the guidance in this Subtopic shall be applied. If the investment banker acquires debt instruments from holders for cash and contemporaneously issues new debt instruments for cash, an extinguishment has occurred only if the two debt instruments have substantially different terms, as defined in Section 470-50-40.</td>
</tr>
</tbody>
</table>

If an intermediary is considered the debtor’s agent under ASC 470-50, the debtor treats the intermediary’s purchases and sales of the debtor’s securities as if they had been executed by the debtor itself. Accordingly:

• If the intermediary purchases the debtor’s outstanding debt from an investor for cash and does not contemporaneously sell new debt of the debtor to the same investor, the guidance in ASC 470-50 does not apply even if the intermediary issues new debt to other investors that did not own the old debt. Instead the debtor would treat the intermediary’s purchase of the outstanding debt as an extinguishment of that debt under ASC 405-20-40-1 (see Section 9.2). The debtor should consider the relevant facts and circumstances to determine whether the settlement of the old debt is contemporaneous with the issuance of any new debt to the same investor.

• If the intermediary exchanges the debtor’s outstanding debt for new debt with the same investor (including transactions that involve a contemporaneous cash exchange, settlement of the original debt, and issuance of new debt to the same investor), the debtor applies ASC 470-50 to determine whether the intermediary’s exchange of debt with the investor should be accounted for as a modification or extinguishment of its outstanding debt.

• If the intermediary purchases debt from the debtor or settles the debtor’s outstanding debt with the debtor, those transactions do not affect the debtor’s accounting (however, such transactions may suggest that the intermediary is acting as a principal). Only the intermediary’s transactions with other investors on behalf of the debtor affect the debtor’s accounting for the debt.

If (1) some of the new debt is issued to investors that held the old debt, (2) some of the new debt is issued to new investors, and (3) the settlement of the old debt is contemporaneous with the issuance of new debt, the debtor would be required under ASC 470-50-55-3 to determine what portion of the new debt is acquired by investors that held the old debt (see Section 10.3.2.2). ASC 470-50 applies to those investors that held the old debt that was replaced by the new debt, and extinguishment accounting
would apply to the portion of the old debt that has been replaced by new debt held by new investors. However, in some cases, it would be acceptable for the issuer to treat an issuance of new debt as a transaction that is separate from the redemption of any existing debt, even if some investors hold both the old and new debt and the transactions are contemporaneous (see Section 10.2.13).

Example 10-11

**Debt Settlement by the Debtor's Agent**

Company X restructured its debt facilities. Bank A, acting as an agent of X, paid off X's old debt and was immediately reimbursed with proceeds from a new X debt offering that it arranged. Because A is an agent of X, the activity of A is treated as if it were the activity of X. If A acquires old debt instruments from investors for cash and contemporaneously issues new debt instruments to the same investors for cash, X would apply the guidance in ASC 470-50 to determine whether it should record an extinguishment of the old debt or account for the transactions as a modification of its old debt.

Example 10-12

**Debt Settlement by the Debtor's Agent**

On December 1, 20X0, Company C issues five-year nonconvertible debt at par for total proceeds of $11 million. Investor Y obtains debt with a principal amount of $6 million, and Investor Q obtains debt with a principal amount of $5 million. The debt pays 10 percent interest annually.

On December 1, 20X2, C engages a bank to act as an agent in the repurchase of C's debt with Y and Q and to help it place new nonconvertible debt. The bank repurchases the original debt held by Y and Q for a total cash payment of $11.567 million, of which $6.309 million is paid to Y and $5.258 million is paid to Q. Simultaneously, the bank places new five-year debt of C with Q and Investor Z, a new investor, at par for total proceeds of $18 million. Investor Q purchases $5 million of the new debt, and Z purchases $13 million of the new debt. The new debt pays 8 percent interest annually.

Company C should apply extinguishment accounting to the $6 million of original debt repurchased from Y since Y is not a continuing creditor and the debt has been extinguished for cash equal to $6.309 million. This component of the transaction is outside the scope of ASC 470-50.

If the transaction qualifies as a market issuance of new debt to replace old debt (see Section 10.2.13), C would be permitted to treat the issuance of new debt to Q as a transaction that is separate from the redemption of the existing debt held by Q. In addition, C would apply extinguishment accounting to the $5 million of original debt repurchased from Q.
Example 10-12 (continued)

If the transaction does not qualify as a market issuance of new debt to replace old debt, C should determine under ASC 470-50 whether to account for the exchange with Q of $5 million of original debt for $5 million of new debt as a modification or an extinguishment of the original debt held by Q. While Q has exchanged original debt with a principal amount of $5 million for a cash payment equal to $5,528 million, it has simultaneously bought new debt from C for cash equal to $5 million. Company C would determine whether the change in terms is significant by assessing whether the change in present value is greater than 10 percent. To do so, it would take the following steps:

1. Determine the present value of the cash flows of the new debt instrument:
   a. Investor Q will receive interest payments at 8 percent annually for five years ($400,000 per year).
   b. Investor Q will receive a principal repayment of $5,000,000 in five years.
   c. Currently, Q receives $5,257,710 for the original debt and pays $5,000,000 for the new debt. The net amount of $257,710 ($5,257,710 – $5,000,000) received by Q is added to the cash flows of the new debt instrument and used to perform the 10 percent cash flow test.
   d. The discount rate is the effective interest rate, for accounting purposes, of the original debt instrument, which is 10 percent.
   e. The present value of the interest and principal payments on the new debt discounted at 10 percent is $4,620,921.
   f. Under the 10 percent cash flow test, the cash flows of the new debt instrument include all cash flows of the new debt instrument plus any amounts paid by the debtor to the creditor, less any amounts received by the debtor from the creditor as part of the exchange. Accordingly, the total present value attributable to the new debt is $4,878,631 ($4,620,921 + $257,710).

2. Determine the present value of the remaining cash flows of the original debt instrument:
   a. Investor Q would have received interest payments at 10 percent annually for three years ($500,000 per year).
   b. Investor Q would have received a principal repayment of $5,000,000 in three years.
   c. The discount rate is the effective interest rate, for accounting purposes, of the original debt instrument, which is 10 percent.
   d. Accordingly, the present value of the cash flows of the original debt instrument is $5,000,000.

3. Determine the percentage of change in the present value of the debt:
   a. The change in present value is $121,369 ($5,000,000 – $4,878,631).
   b. The change as a percentage of the old debt is 2.43 percent ($121,369 ÷ $5,000,000).

Because the change is less than 10 percent and the debt does not contain any conversion features before or after the modification or exchange, the debt instruments would not be considered substantially different (see Section 10.3). Accordingly, C would apply modification accounting to the exchange of debt with Q (see Section 10.4.3). Investor Z is a new creditor and, accordingly, the issuance of debt to Investor Z is outside the scope of ASC 470-50 and should instead be accounted for as a new debt issuance.
10.5.3.4 Modified Remarketable Put Bond Transactions

At the 2003 AICPA Conference on Current SEC Developments, SEC Professional Accounting Fellow Robert Comerford provided an example of the application of ASC 470-50 to a modified remarketable put bond transaction. Mr. Comerford's remarks suggest that an intermediary may perform a dual role in certain transactions involving the contemporaneous repurchase and reissuance of debt. In his example, the intermediary acts both (1) in a principal capacity by (a) exercising a call option attached to the debt that permits it to purchase the debt at a specified price from third-party investors and (b) selling the debt to the debtor and (2) as the debtor's agent by selling modified debt to investors:

Assume that a company issues a 5-year bond for $1,000, which is also the bond's face value. Two years later, the issuer's investment bank may call the bond from its holder for $1,000, reset the interest rate on the bond according to a predetermined formula and then sell the bond bearing this new interest rate to new investors for the bond's then-current fair value. The predetermined formula has a fixed component plus a newly determined spread reflecting the credit risk of the issuer as of the reset date. If the investment bank does not call the bond the original investor must sell the bond back to the issuer for $1,000. The issuer's participation on the reset date is limited to either of the following scenarios. If the investment bank exercises its call option and remarkets the bond the issuer must pay the bond's new interest rate until the bond's final maturity date. If the investment bank does not exercise its call, the issuer must repurchase the bond from the original investor.

Some issuers have considered increasing the face value of their . . . remarketed bonds [and reducing] the interest rate on the bonds to a market-based rate appropriate to 3-year debt of the issuer. This matching of the remarketed bond's new face value with its expected issuance price has the potential to reduce the credit spread demanded by the new investors, thus reducing the issuer's overall cost of funds.

However, as is often the case with structured transactions, the little changes that I have mentioned may have unintended consequences for the issuer. Because increasing the remarketable put bond's face value and reducing its coupon to a market-based rate is not contemplated in the original terms of the bond, these modifications require evaluation under the guidance contained in [ASC 470-50]. . . .

The Staff believes that a thorough analysis of the modified remarketing transaction that I have described causes the investment bank to be viewed as playing a dual role in the transaction. The investment bank may be viewed as that of a principal in the first component of the transaction involving the acquisition of the bond from the original investor, the resetting of the bond's interest rate pursuant to the bond's original terms and the subsequent tendering of these instruments back to the issuer at a price in excess of the instrument's face value. Once the issuer has increased the principal amount and decreased the coupon of the replacement bond, the investment bank's role is that of the issuer's agent conducting the placement of a modified bond to a new investor.

The Implementation Guidelines in [ASC 470-50] list four indicators to consider when evaluating whether an intermediary is acting as a principal or as the issuer's agent. . . . I would like to walk through those indicators as they pertain to the investment bank's role in placing the modified bonds with new investors.

The first indicator involves the risk of loss, if any, that the intermediary is exposed to. Investment banks typically obtain “soft bids” for the replacement bond prior to, or concurrent with, making the decision to exercise their call option on the old bond. By obtaining soft bids the investment bank can determine whether demand for the replacement bond is sufficient to ensure its successful placement. This significantly reduces the investment bank's exposure to market risk associated with the remarketed instruments, thus pointing towards the investment bank's role being that of an agent.

The second indicator examines whether the investment bank is placing the modified bond on a best efforts or a firmly committed basis. Facts and circumstances could lead one to build an argument either way.

The third indicator considers whether the issuer directs the intermediary's actions. Although the issuer may not have conceived the idea of increasing the face amount of the bond and decreasing the coupon, these actions require the issuer's active involvement and ultimately its approval. Therefore, we believe the issuer essentially directs the investment bank's actions, which suggests the investment bank is an agent.

The final indicator relates to whether the intermediary's compensation is limited to a pre-established fee or is derived from gains based on the value of the security to be issued by the issuer. In its capacity as placement agent for the modified bond, the investment bank typically is compensated by a pre-established fee. This further points towards the investment bank's role being that of the issuer's agent.
We believe that this analysis provides a firm basis for concluding that the investment bank acts as the issuer's agent in the debt placement component of these modified remarketing transactions. Because this amounts to the transaction being the issuer's acquisition of its own bonds from one investor coupled with the issuance of a modified bond to a new investor, [ASC 470-50] requires that this transaction be accounted for as the extinguishment and de-recognition of the old bond and the recognition of the new bond at its fair value with the difference between these two amounts recognized in the income statement as an extinguishment loss.

Mr. Comerford's remarks highlight that a contemporaneous debt repurchase and reissuance should be analyzed as a debt extinguishment under ASC 405-20 and not as a modification or exchange under ASC 470-50 if the intermediary is acting as a principal in the debt repurchase and as the debtor's agent in the debt reissuance. The intermediary's purchase of debt securities from investors is considered a transfer among debt holders that does not affect the debtor's accounting since the intermediary is acting as a principal in a transaction to which the debtor is not a party (see Section 10.2.8). However, the debtor's repurchase of debt from the intermediary would be analyzed as a debt extinguishment because the debtor is viewed as having repurchased debt from one investor (the intermediary) by using proceeds from debt issued to other investors (since the intermediary is acting as an agent in the debt placement. If the intermediary instead had acted as the debtor's agent in both the purchase and reissuance of debt to the same investors, those transactions would have been analyzed as a debt modification or exchange under ASC 470-50 (see Section 10.2.2).

10.6 Modifications and Exchanges of Credit Facilities

10.6.1 Background

As discussed in Chapter 5, an entity might incur costs and fees to obtain a commitment from a prospective creditor to obtain funds on specified terms and conditions in the future. Such commitments fall into two broad categories: (1) lines of credit and other revolving-debt commitments that permit the entity to borrow, repay amounts borrowed, and reborrow amounts previously repaid, and (2) delayed-draw term loan commitments and other nonrevolving commitments that do not permit the entity to reborrow amounts repaid (see Section 2.3.3). This section discusses the accounting for modifications and exchanges of the following types of arrangements:

- Line-of-credit and other revolving-debt arrangements (see Section 10.6.2 below).
- Delayed-draw term loan commitments (see Section 10.6.3).
- Credit facilities that include both drawn and undrawn components (see Section 10.6.4).

10.6.2 Modifications of Line-of-Credit and Other Revolving-Debt Arrangements

10.6.2.1 General

When an entity modifies or exchanges a line-of-credit or revolving-debt arrangement with the same creditor, it should evaluate how to account for any unamortized deferred costs associated with the existing arrangement (see Section 5.4) as well as any fees paid to the creditor and any costs paid to third parties in connection with the modification or exchange. ASC 470-50-40-21 requires an entity to perform a borrowing-capacity analysis to determine the appropriate accounting for such modifications or exchanges (see Section 10.6.2.3).
### Scope

The guidance in this Subtopic is limited to modifications to or exchanges of line-of-credit or revolving-debt arrangements by a debtor and a creditor (the same parties that were involved in the original line-of-credit or revolving-debt arrangement) in a nontroubled situation.

The guidance in ASC 470-50-40-21 through 40-23 applies when a debtor modifies or exchanges a line-of-credit or revolving-debt arrangement with the same creditor or group of creditors. If an entity terminates an existing line-of-credit or revolving-debt arrangement and contemporaneously obtains a new line-of-credit or revolving-debt arrangement from the same creditor or group of creditors, for example, those transactions should be analyzed as an exchange of the existing line-of-credit or revolving-debt arrangement under ASC 470-50-40-21 through 40-23.

ASC 470-50-40-21 through 40-23 apply irrespective of whether a line-of-credit or revolving-debt arrangement is replaced by a new line-of-credit or revolving-debt arrangement or term debt. For example, if a debtor converts a revolving-debt arrangement into a term-debt arrangement, it should perform the borrowing-capacity test in ASC 470-50-40-21 to determine the appropriate accounting for any deferred costs as well as any fees or costs associated with the modification or exchange.

If, because of an entity's violation of a covenant in a line-of-credit or revolving-debt arrangement, outstanding amounts become repayable on demand, the creditor might agree to waive the covenant violation in exchange for a fee. Such a fee payment would be analyzed as a modification of the line-of-credit or revolving-debt arrangement even if no other terms in the arrangement are modified (see Section 10.2.4 for analogous guidance).

It would generally be acceptable to apply ASC 470-50-40-21 to all of the elements of a modification or exchange of a line-of-credit arrangement when the same group of individual creditors participates in both the original arrangement and the new arrangement (i.e., there are no new creditors or departing creditors in the overall arrangement). That is, if only a portion of the total maximum credit availability among individual creditors within the same creditor group has shifted, that alone would not result in a requirement for an entity to write off any portion of the unamortized deferred costs related to the original arrangement.

The guidance in ASC 470-50-40-21 through 40-23 does not apply if (1) the modification represents a TDR (see Chapter 11) or (2) the debtor replaces the arrangement with a new arrangement with a different creditor. If a debtor terminates an existing line-of-credit or revolving-debt arrangement and obtains a new line-of-credit or revolving-debt arrangement from a different creditor, the debtor should write off all the unamortized deferred costs of the old arrangement as well any costs incurred to terminate the arrangement with the original creditor.
10.6.2.3 **Borrowing-Capacity Analysis**

470-50

40-21 Modifications to or exchanges of line-of-credit or revolving-debt arrangements resulting in either a new line-of-credit or revolving-debt arrangement or resulting in a traditional term-debt arrangement shall be evaluated in the following manner:

a. The debtor shall compare the product of the remaining term and the maximum available credit of the old arrangement (this product is referred to as the borrowing capacity) with the borrowing capacity of the new arrangement.

b. If the borrowing capacity of the new arrangement is greater than or equal to the borrowing capacity of the old arrangement, then any unamortized deferred costs, any fees paid to the creditor, and any third-party costs incurred shall be associated with the new arrangement (that is, deferred and amortized over the term of the new arrangement).

c. If the borrowing capacity of the new arrangement is less than the borrowing capacity of the old arrangement, then:
   1. Any fees paid to the creditor and any third-party costs incurred shall be associated with the new arrangement (that is, deferred and amortized over the term of the new arrangement).
   2. Any unamortized deferred costs relating to the old arrangement at the time of the change shall be written off in proportion to the decrease in borrowing capacity of the old arrangement. The remaining unamortized deferred costs relating to the old arrangement shall be deferred and amortized over the term of the new arrangement.

40-23 See Example 1 (paragraph 470-50-55-10) for an illustration of this guidance.

The accounting for a modification or exchange of a line-of-credit or revolving-debt arrangement with the same creditor depends on whether the debtor’s borrowing capacity has decreased. ASC 470-50-40-21 through 40-23 require the debtor to calculate the borrowing capacity by multiplying the arrangement’s (1) remaining term and (2) maximum available credit (i.e., the full committed amount including any amounts drawn). This calculation does not depend on the measure of time used for the remaining term (e.g., whether the remaining term is measured in months, quarters, or years) except that the debtor must apply a consistent measure when calculating the borrowing capacity of both the original and the new arrangement.

**Example 10-13**

**Calculation of Borrowing Capacity**

A revolving-debt arrangement has a remaining term of five years. The outstanding amount currently drawn is $10 million, and the remaining undrawn amount is $15 million. Under ASC 470-50, the borrowing capacity of this arrangement is $125 million \([5 \times ($10\text{ million} + $15\text{ million})]\).
The guidance requires any unamortized deferred costs of the old arrangement, and any costs and fees incurred in connection with a modification or exchange, to be deferred and amortized over the term of the new arrangement except if the borrowing capacity under the new arrangement is less than that under the old arrangement. In that case, unamortized deferred costs of the old arrangement are written off in proportion to the decrease in the borrowing capacity.

<table>
<thead>
<tr>
<th>Borrowing Capacity Under the New Arrangement</th>
<th>Accounting for Unamortized Deferred Costs of the Old Arrangement</th>
<th>Accounting for Costs and Fees Paid in Connection With the Modification or Exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equals or exceeds the borrowing capacity under the old arrangement</td>
<td>Deferred and amortized over the term of the new arrangement</td>
<td>Deferred and amortized over the term of the new arrangement</td>
</tr>
<tr>
<td>Is less than the borrowing capacity under old arrangement</td>
<td>Written off in proportion to the decrease in the borrowing capacity. The remaining amount is deferred and amortized over the term of the new arrangement</td>
<td>Deferred and amortized over the term of the new arrangement</td>
</tr>
</tbody>
</table>

### 10.6.2.4 Illustrations

**ASC 470-50**

**Example 1: Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements**

**55-10** This Example illustrates the application of the guidance in paragraphs 470-50-40-21 through 40-22 for changes in line-of-credit or revolving-debt arrangements.

**55-11** Terms of original arrangement are as follows:

- a. Five-year term (three years remaining)
- b. $10 million commitment amount
- c. The borrowing capacity under the original arrangement at the time of the change is $30 million, the product of the remaining term (3 years) and the commitment amount ($10 million).

**55-12** The following situations represent changes that are made (with the same creditor) to the original terms:

- a. The commitment amount is increased to $15 million, the term of the new arrangement remains at 3 years (borrowing capacity is $45 million).
- b. The commitment amount is decreased to $2 million, the term of the new arrangement is 5.5 years (borrowing capacity is $11 million).
- c. The original revolver is replaced with a 3-year, $7.5 million term loan, with principal due at the end of 3 years (borrowing capacity is $22.5 million).
- d. The original revolver is replaced with a 3-year, $10 million term loan, with principal due at the end of 3 years (borrowing capacity is $30 million).
ASC 470-50 (continued)

55-13 In all of the situations described, at the time the change is made to the original arrangement, $150,000 of unamortized costs relating to the original arrangement remain on the debtor's balance sheet; the debtor pays a fee of $100,000 to the creditor; and the debtor incurs third-party costs of $200,000.

The following illustrates the various situations described in this Example.

<table>
<thead>
<tr>
<th>Case</th>
<th>Old Borrowing Capacity</th>
<th>New Borrowing Capacity</th>
<th>Accounting Treatment of Unamortized Deferred Costs</th>
<th>Accounting Treatment of Fees and Third-Party Costs Incurred</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>30 million</td>
<td>45 million</td>
<td>$150,000 is amortized over 3 years.</td>
<td>$300,000 is deferred and amortized over 3 years.</td>
</tr>
<tr>
<td>B</td>
<td>30 million</td>
<td>11 million</td>
<td>63 percent of the unamortized costs ($94,500) are written off; the remaining costs ($55,500) are amortized over 5.5 years.</td>
<td>$300,000 is deferred and amortized over 5.5 years.</td>
</tr>
<tr>
<td>C</td>
<td>30 million</td>
<td>22.5 million</td>
<td>25 percent of the unamortized costs ($37,500) are written off; the remaining costs ($112,500) are amortized over 3 years.</td>
<td>$300,000 is deferred and amortized over 3 years.</td>
</tr>
<tr>
<td>D</td>
<td>30 million</td>
<td>30 million</td>
<td>$150,000 is amortized over 3 years.</td>
<td>$300,000 is deferred and amortized over 3 years.</td>
</tr>
</tbody>
</table>

Example 10-14

Issuance of Warrants as Consideration for Extension of Line of Credit

Entity C obtains an extension of the remaining term of an existing line of credit in exchange for equity-classified warrants on C's common stock. No other terms in the arrangement are modified. The fair value of the warrants should be analyzed as the payment of a fee to the creditor (i.e., a debit to “deferred financing costs” and a credit to “equity”). Because the term was extended and the maximum available credit remained the same, the borrowing capacity has increased. Therefore, the fair value of the warrants should be deferred and amortized over the term of the modified arrangement.

Example 10-15

Treatment of Waiver Fee and Third-Party Costs

As a result of Entity B's violation of a covenant on a line-of-credit arrangement, outstanding amounts have become repayable on demand. The creditor agrees to waive the covenant violation in exchange for a fee. Further, B incurs legal fees in connection with the waiver. No other terms in the arrangement are modified and the borrowing capacity remains unchanged. Nevertheless, the payment of the waiver fee represents a modification of the original arrangement under ASC 470-50-40-21 through 40-23. Therefore, the waiver fee and the third-party legal costs should be deferred and amortized over the term of the new arrangement, which is equal to the remaining term of the original arrangement.
Example 10-16

Modification That Involves a Reduction of the Borrowing Capacity of a Line of Credit

Entity D and Bank B agree to amend the terms of D’s revolving-debt arrangement to (1) reduce the total amount available from $250 million to $200 million, (2) extend the remaining term from two and a half years to three years, (3) increase the interest rate, and (4) modify certain covenants. In exchange for the amendment, B charges a fee of $3 million. At the time of the amendment, D had an asset of $5 million attributable to remaining unamortized deferred financing costs related to the original arrangement.

ASC 470-50-40-21(a) requires the borrowing capacity of a revolving-debt arrangement to be calculated as the product of the maximum borrowing capacity and remaining term under the arrangement. Accordingly, D determines that the borrowing capacity under the old arrangement is $625 million ($250 million × 2½ years) and the borrowing capacity after the amendment is $600 million ($200 million × 3 years):

<table>
<thead>
<tr>
<th>Original Arrangement</th>
<th>Amended Arrangement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum available credit</td>
<td>$250 million</td>
</tr>
<tr>
<td>Remaining term</td>
<td>2½ years</td>
</tr>
<tr>
<td>Borrowing capacity</td>
<td>$625 million</td>
</tr>
</tbody>
</table>

Because the borrowing capacity of the new arrangement ($600 million) is less than the borrowing capacity of the old arrangement ($625 million), D is required under ASC 470-50-40-21(c) to write off the existing unamortized deferred costs in proportion to the decrease in the borrowing capacity. The proportion written off is 4 percent ([($625 million – $600 million) ÷ $625 million] = 4%). Accordingly, $200,000 is immediately expensed through earnings (4% × $5 million = $200,000). The remaining unamortized deferred costs of $4.8 million and the modification fee of $3 million are deferred as an asset and amortized on a straight-line basis (see Section 5.4) over the 36 months to the revised maturity date of the arrangement.

Example 10-17

Modification That Involves a Reduction of the Borrowing Capacity of a Line of Credit and Conversion of Outstanding Amount to a Term Loan

A revolving-debt arrangement has a remaining term of five years and remaining unamortized deferred costs of $10 million. The outstanding amount currently drawn is $100 million and the remaining amount available to be drawn is $150 million. Under ASC 470-50-40-21(a), the borrowing capacity of this arrangement equals $1,250 million (5 × ($100 million + $150 million)).

<table>
<thead>
<tr>
<th>Original Arrangement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum available credit</td>
</tr>
<tr>
<td>Remaining term</td>
</tr>
<tr>
<td>Borrowing capacity</td>
</tr>
</tbody>
</table>

The revolving-debt arrangement is modified to reduce the remaining term to three years and the amount available to be drawn to $100 million. Further, the outstanding amount currently drawn as of the modification date ($100 million) is converted into a traditional term-debt arrangement with a maturity of five years. The debtor pays creditor fees of $2 million and incurs third-party costs of $1 million in connection with the modification.
Example 10-17 (continued)

Under ASC 470-50-40-21(a) and 40-22, the borrowing capacity of the modified arrangement is calculated to reflect the borrowing capacity of both the modified revolving-debt arrangement and the new term-debt arrangement. Therefore, the borrowing capacity of the new arrangement equals $800 million \((3 \times 100 \text{ million}) + (5 \times 100 \text{ million})\).

<table>
<thead>
<tr>
<th></th>
<th>New Revolver</th>
<th>New Term Debt</th>
<th>New Arrangement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum available credit</td>
<td>$100 million</td>
<td>$100 million</td>
<td></td>
</tr>
<tr>
<td>Remaining term</td>
<td>3 years</td>
<td>5 years</td>
<td></td>
</tr>
<tr>
<td>Borrowing capacity</td>
<td>$300 million</td>
<td>$500 million</td>
<td>$800 million</td>
</tr>
</tbody>
</table>

Because the borrowing capacity of the new arrangement ($800 million) is less than the borrowing capacity of the old arrangement ($1,250 million), the existing unamortized deferred costs must be written off under ASC 470-50-40-21(c) in proportion to the decrease in the borrowing capacity. The proportion written off is 36 percent \(\left(\frac{1,250 \text{ million} - 800 \text{ million}}{1,250 \text{ million}}\right) \times 100 = 36\%\). Accordingly, $3.6 million is immediately expensed through earnings (36% × $10 million = $3.6 million). The remaining unamortized deferred costs of $6.4 million and the costs and fees incurred in connection with the modification of $3 million are deferred.

Because some of the revolving-debt arrangement was replaced with a traditional term-debt arrangement, a portion of the total amount of deferred costs of $9.4 million should be allocated to the traditional term-debt arrangement (e.g., on a relative-borrowing-capacity basis) and treated as an issuance cost of the term debt in a manner similar to a debt discount. The portion of the deferred costs allocated to the revolving-debt arrangement is deferred as an asset and amortized as an expense over the remaining term of the revolving-debt arrangement.

Example 10-18

Modification of Line of Credit That Involves Multiple Creditors

Entity X had a revolving line-of-credit arrangement with a remaining two-year term that contained a total maximum available credit of $50 million (the “original arrangement”). The total maximum credit was provided through the following legally binding lending commitments with three separate creditors:

- Bank A — total lending commitment of $20 million.
- Bank B — total lending commitment of $20 million.
- Bank C — total lending commitment of $10 million.

Entity X replaces the original arrangement with a revolving line-of-credit arrangement with a five-year term that contains a total maximum available credit of $75 million (the “new arrangement”). The total maximum credit is provided through the following legally binding lending commitments with three separate creditors:

- Bank A — total lending commitment of $25 million.
- Bank B — total lending commitment of $25 million.
- Bank D — total lending commitment of $25 million.

When X replaced the original arrangement, it had recognized unamortized deferred fees of $400,000 associated with the original arrangement ($160,000 to A, $160,000 to B, and $80,000 to C) and unamortized deferred third-party costs of $40,000. In conjunction with the issuance of the new arrangement, X paid fees of $1.5 million to the creditors ($500,000 to each bank) and incurred third-party costs of $100,000.

In accordance with ASC 470-50-40-22, X should apply ASC 470-50-40-21 to the unamortized deferred fees and costs associated with the original arrangement related to the parties involved in the original arrangement (A and B). Entity X should not apply ASC 470-50-40-21 to the unamortized deferred fees and costs associated with the original arrangement related to C because C is not a creditor in the new arrangement. In addition, X should not apply ASC 470-50-40-21 to the fees and third-party costs associated with the new arrangement related to D because D was not a creditor in the original arrangement.
### Example 10-18 (continued)

The following table summarizes the appropriate accounting for the fees and costs as a result of the exchange:

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Fees and Costs Associated With the Original Arrangement</th>
<th>Fees and Costs Associated With the New Arrangement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bank A</strong></td>
<td>The borrowing capacity with Bank A increased; therefore, under ASC 470-50-40-21, the unamortized deferred fees of $160,000 associated with the original arrangement are deferred and amortized over the term of the new arrangement.</td>
<td>Under ASC 470-50-40-21, the $500,000 that X paid to A is associated with the new arrangement and is deferred and amortized over the term of the new arrangement.</td>
</tr>
<tr>
<td><strong>Bank B</strong></td>
<td>The borrowing capacity with Bank B increased; therefore, under ASC 470-50-40-21, the unamortized deferred fees of $160,000 associated with the original arrangement are deferred and amortized over the term of the new arrangement.</td>
<td>Under ASC 470-50-40-21, the $500,000 that X paid to B is associated with the new arrangement and is deferred and amortized over the term of the new arrangement.</td>
</tr>
<tr>
<td><strong>Bank C</strong></td>
<td>ASC 470-50-40-21 does not apply since C is not a creditor in the new arrangement. Rather, the termination of the lending arrangement with C is considered an extinguishment that results in the write-off of the $80,000 of unamortized deferred fees associated with the original arrangement.</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Bank D</strong></td>
<td>N/A</td>
<td>ASC 470-50-40-21 does not apply since D was not a creditor in the original arrangement. Nevertheless, in accordance with ASC 835, the $500,000 that X paid to D should be deferred and amortized over the term of the new arrangement.</td>
</tr>
<tr>
<td><strong>Third-party costs</strong></td>
<td>The unamortized costs associated with the original arrangement should be written off in proportion to the unamortized deferred fees associated with the original arrangement that were written off (20%, or $80,000 of the $400,000 that was written off). This results in a write-off of $8,000 of the unamortized deferred third-party costs associated with the original arrangement.</td>
<td>Under ASC 470-50-40-21 and ASC 835, the $100,000 of third-party costs incurred on the new arrangement are associated with the new arrangement and are deferred and amortized over the term of the new arrangement.</td>
</tr>
</tbody>
</table>

In addition, note that it would generally be acceptable to apply ASC 470-50-40-21 to all the elements of a modification or exchange of a line-of-credit arrangement when the same group of individual creditors participates in both the original arrangement and the new arrangement (i.e., there are no new creditors or departing creditors in the overall arrangement). That is, the mere shift of a portion of the total maximum credit availability among individual creditors within the same creditor group would not itself require an entity to write off any portion of the unamortized deferred costs related to the original arrangement (see Section 10.6.2.2). If, in the example above, A, B, and C were the creditors of the new arrangement and individually provided a credit availability of $55 million, $10 million, and $10 million, respectively, because the borrowing capacity of the new arrangement in total would be greater than that of the original arrangement in total, X would not be required to write off any of the unamortized deferred fees and costs related to the original arrangement notwithstanding the fact that $10 million of B's original credit commitment has been replaced by an additional credit commitment of A.
Example 10-18 (continued)

In certain line-of-credit arrangements, the contractual lending arrangement is between a debtor and a lead bank. Under the definition of “loan participation” in ASC 470-50-20 (see Section 10.3.2.4), participating banks are not direct creditors; rather, they have an interest represented by a certificate of participation from the lead bank. In these situations, the lead bank is considered the sole creditor. Thus, in a modification or exchange of a line-of-credit arrangement between a debtor and the lead bank, the debtor would apply ASC 470-50-40-21 to the entire modification or exchange. Accordingly, if A were the lead bank in both the original arrangement and new arrangement, because the borrowing capacity of the new arrangement would be greater than that of the original arrangement, the entire amount of unamortized deferred fees and costs associated with the original arrangement and all of the fees and costs incurred to enter the new arrangement would be deferred and amortized over the term of the new arrangement. The change in the composition of the participating banks (i.e., B, C, and D) would therefore have no effect on the accounting.

10.6.3 Modifications of Delayed-Draw Term Loan Commitments

As discussed in Section 5.3, an entity might defer costs associated with a delayed-draw term loan commitment as an asset before the issuance of the debt. ASC 470-50 does not specifically address how the holder of a delayed-draw term loan commitment should account for a modification or exchange of such a commitment if no amount has been drawn. It is acceptable to apply the guidance in ASC 470-50-40-21 through 40-23 (see Section 10.6.2) on modifications to line-of-credit or revolving-debt arrangements to such modifications. For amounts that have been drawn under a delayed-draw term loan commitment, an entity should apply the guidance on debt modifications and exchanges in ASC 470-50-40-6 through 40-12 (see Sections 10.2 through 10.5).

10.6.4 Modifications to Credit Facilities That Include Both Drawn and Undrawn Components

Credit facilities often include a combination of term loans, delayed-draw term loan commitments, and line-of-credit or revolving-debt arrangements. While ASC 470-50 addresses the evaluation of modifications and exchanges of term debt (see Sections 10.2 through 10.5) and modifications of line-of-credit and revolving-debt arrangements (see Section 10.6.2), it does not specifically address amendments to credit facilities that include a combination of types except for modifications of revolving-debt arrangements that are modified into, or exchanged for, term loans (see Section 10.6.2.2).

If an outstanding term loan is modified or exchanged so that it becomes an amount drawn under a line-of-credit or revolving-debt arrangement with the same creditor, the debtor should apply the guidance on modifications and exchanges of term-debt arrangements (such as the guidance in ASC 470-50-40-10 on the 10 percent cash flow test) to the associated debt (see Sections 10.2 through 10.5). In evaluating whether to account for the original term loan as extinguished, the debtor would treat the amount drawn after the amendment as a term loan with payment terms that are consistent with those of amounts drawn under the new line-of-credit or revolving-debt arrangement.

ASC 470-50-40-21 states that it applies to modifications to, or exchanges of, “line-of-credit or revolving-debt arrangements resulting in either a new line-of-credit or revolving-debt arrangement or resulting in a traditional term-debt arrangement.” If a line-of-credit or revolving-debt arrangement is modified or exchanged so that it becomes, in whole or in part, a term-debt arrangement or delayed-draw term loan commitment with the same creditor, the debtor should apply the guidance on modifications of line-of-credit or revolving-debt arrangements (see Section 10.6.2). Note that it would apply this guidance even if amounts were drawn under a line-of-credit or revolving-debt arrangement before its modification or exchange. If the borrowing capacity before the amendment exceeds the borrowing capacity after the amendment, a proportionate amount of the current unamortized deferred costs
associated with the line-of-credit or revolving-debt arrangement is expensed and the remaining amount is allocated among any continuing line-of-credit or revolving-debt arrangement, delayed-draw term loan commitment, and term loan on a systematic and rational basis (e.g., on the basis of relative borrowing capacity). If the borrowing capacity after the amendment equals or exceeds the borrowing capacity before the amendment, the current amount of unamortized deferred costs associated with the line-of-credit or revolving-debt arrangement is allocated among any continuing line-of-credit or revolving-debt arrangement, delayed-draw term loan commitment, and term loan on a systematic and rational basis (e.g., first to the continuing line-of-credit or revolving-debt arrangement in proportion to the borrowing capacity that remains under that component of the arrangement and then to the new term loan). Any amounts allocated to the new term loan are accounted for as debt issuance costs of that debt (see Section 5.3.3).

If the original credit facility includes both outstanding term debt and a line of credit or revolving debt, it is often appropriate to analyze the modification or exchange separately for each of those components on the basis of the above guidance (e.g., when only one component is modified). Any amount of term debt outstanding before the amendment that is reallocated to an amount drawn under a line-of-credit or revolving-debt arrangement after the amendment would be analyzed under the guidance on modifications and exchanges of term debt. Any amount that was drawn under a line-of-credit or revolving-debt arrangement before the amendment that becomes an amount drawn under a term-debt arrangement after the modification or exchange is analyzed in accordance with the guidance on modifications of line-of-credit or revolving-debt arrangements. In some circumstances, it may be appropriate to analyze the modification or exchange in combination on the basis of the predominant characteristics of the overall credit facility (e.g., amounts are fully drawn and an increase in the interest rate of one component is compensated by a decrease in the interest rate of the other component). An entity should allocate the fees and costs incurred to amend a credit facility to the different components of the facility by using a reasonable and systematic approach that is consistently applied (e.g., relative fair value).

If a credit facility involves multiple lenders, and an individual creditor no longer participates in the credit facility, any term loan with that creditor is accounted for as an extinguishment unless the replacement of an original creditor with a new creditor, in substance, represents a transfer of the existing debt to a new debt holder (see Section 10.2.8). Any deferred costs related to a line-of-credit or revolving-debt arrangement or delayed-draw term loan commitment with a creditor that no longer participates in the credit facility would be written off through current-period earnings. If a new creditor is added to the credit facility, any term loan with that creditor is recognized as a new term loan and any costs attributable to a line-of-credit or revolving-debt arrangement or delayed-draw term loan commitment with that creditor is deferred as an asset, if appropriate.
The table below summarizes the above considerations.

<table>
<thead>
<tr>
<th>Individual Creditors</th>
<th>Original Credit Facility</th>
<th>Amended Credit Facility</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continuing creditor</td>
<td>Term debt</td>
<td>Term debt</td>
<td>Perform the 10 percent cash flow test and apply the guidance on conversion features (see Section 10.3) to determine whether the original term debt should be treated as modified or extinguished (see Section 10.4).</td>
</tr>
<tr>
<td>Line of credit or revolver</td>
<td>Line of credit or revolver</td>
<td>Perform the borrowing-capacity test (see Section 10.6.2) to determine the accounting for any deferred costs.</td>
<td></td>
</tr>
<tr>
<td>Term debt</td>
<td>Line of credit or revolver</td>
<td>Perform the 10 percent cash flow test on the basis of the amount drawn and apply the guidance on conversion features (see Section 10.3) to determine whether the original term debt should be treated as modified or extinguished (see Section 10.4).</td>
<td></td>
</tr>
<tr>
<td>Line of credit or revolver</td>
<td>Term debt</td>
<td>Perform the borrowing-capacity test (see Section 10.6.2) to determine the accounting for any deferred costs.</td>
<td></td>
</tr>
<tr>
<td>No longer creditor</td>
<td>Term debt</td>
<td>N/A</td>
<td>Apply debt extinguishment accounting (see Section 9.3) to the related term loan.</td>
</tr>
<tr>
<td>Line of credit or revolver</td>
<td>N/A</td>
<td>Expense the related deferred financing costs.</td>
<td></td>
</tr>
<tr>
<td>New creditor</td>
<td>N/A</td>
<td>Term debt</td>
<td>Recognize as a new term loan (see Chapters 4 and 5).</td>
</tr>
<tr>
<td></td>
<td>N/A</td>
<td>Line of credit or revolver</td>
<td>Recognize an asset for the related deferred financing costs (see Section 5.4).</td>
</tr>
</tbody>
</table>
Chapter 11 — Troubled Debt Restructurings

11.1 Background

ASC 470-60

05-1 This Subtopic addresses measurement, derecognition, disclosure, and implementation guidance issues concerning troubled debt restructurings focused on the debtor’s records. The creditor’s accounting is discussed in Subtopic 310-40.

If a creditor anticipates that a debtor might be unable to pay its outstanding debt obligations as they become due, the creditor may be willing to grant the debtor a concession. For example, the creditor might agree to reduced or extended payment terms or a settlement of some or all of the obligation through the transfer of assets or equity shares (see Section 11.2 below). By granting a concession, the creditor hopes to improve its prospects of recovering as much as possible of its investment and avoiding a costly legal process (e.g., foreclosure, bankruptcy proceedings, or other adverse consequences of an event of default).

Under ASC 470-60, a debt restructuring qualifies as a TDR if both of the following two criteria are met: (1) the debtor is experiencing financial difficulties and (2) the creditor for economic or legal reasons related to such difficulties has granted the debtor a concession that it would not otherwise consider (see Section 11.3). ASC 470-60 discusses special accounting, presentation, and disclosure requirements related to TDRs (see Sections 11.4 and 11.5).

11.2 Scope

11.2.1 General

ASC 470-60

15-1 The guidance in this Subtopic applies to all debtors.

15-2 The guidance in this Subtopic applies to all troubled debt restructurings by debtors.

15-4 . . . Payables that may be involved in troubled debt restructurings commonly result from borrowing of cash, or purchasing goods or services on credit. Examples are accounts payable, notes, debentures and bonds (whether those payables are secured or unsecured and whether they are convertible or nonconvertible), and related accrued interest, if any. . . .

15-4A In this Subtopic, a receivable or a payable (collectively referred to as debt) represents a contractual right to receive money or a contractual obligation to pay money on demand or on fixed or determinable dates that is already included as an asset or a liability in the creditor’s or debtor’s balance sheet at the time of the restructuring.
### ASC 470-60 (continued)

**15-9** A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

- a. Transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession)
- b. Issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest
- c. Modification of terms of a debt, such as one or a combination of any of the following:
  1. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt
  2. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk
  3. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement
  4. Reduction (absolute or contingent) of accrued interest.

**15-11** For purposes of this Subtopic, none of the following are considered troubled debt restructurings:

- a. Changes in lease agreements (for guidance, see Topic 840)
- b. Changes in employment-related agreements, for example, pension plans and deferred compensation contracts
- c. Unless they involve an agreement between debtor and creditor to restructure, neither of the following:
  1. Debtors’ failures to pay trade accounts according to their terms
  2. Creditors’ delays in taking legal action to collect overdue amounts of interest and principal.

### Pending Content (Transition Guidance: ASC 842-10-65-1)

**15-11** For purposes of this Subtopic, none of the following are considered troubled debt restructurings:

- a. Lease modifications (for guidance, see Topic 842)
- b. Changes in employment-related agreements, for example, pension plans and deferred compensation contracts
- c. Unless they involve an agreement between debtor and creditor to restructure, neither of the following:
  1. Debtors’ failures to pay trade accounts according to their terms
  2. Creditors’ delays in taking legal action to collect overdue amounts of interest and principal.

**15-13** For further guidance on determining whether a modification or exchange is a troubled debt restructuring, see paragraphs 470-60-55-4 through 55-7. If a debtor concludes that the modification or exchange is not within the scope of this Subtopic, the debtor would apply the provisions of Subtopic 470-50.

If a debtor undertakes any of the following transactions involving its outstanding debt, it should evaluate whether the transaction qualifies as a TDR under ASC 470-60 (see Section 11.3):

- **A modification of terms** — The creditor might agree to extend the terms by deferring the timing of the contractual interest or principal payments due. Alternatively, the creditor might agree to reduce the amounts due by (1) decreasing the contractual interest rate to a below-market interest rate or (2) forgiving a portion of the principal amount or previously accrued interest. Further, the modification might make payment terms contingent on, for example, the debtor’s revenue.
• An exchange of debt instruments — The debtor and creditor might agree to exchange the outstanding debt instrument for a new debt instrument with terms that are more favorable to the debtor.

• Transfer of assets in full or partial satisfaction of the debt — The debtor might transfer cash, trade receivables, real estate, or other assets to the creditor to fully or partially satisfy the debt.

• Grant of equity interest in full or partial satisfaction of the debt — The debtor might transfer an equity interest (such as shares of common or preferred stock or warrants on such shares) to the creditor to satisfy fully or partially the obligation even though the debt was not convertible into such an equity interest under the debt's original contractual terms.

Note that a restructuring that extends the debt's maturity date might qualify as a TDR under ASC 470-60 even if the principal balance and the stated interest rate remain unchanged. ASC 470-60-15-9(c) states, in part, that a TDR may include “[e]xtension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.” If the stated interest rate on the restructured loan is lower than the current market rate for a new loan with similar risk that a creditor would be willing to make, the restructuring might be deemed a concession (see Section 11.3.3).

Further, a debt restructuring might represent a TDR even if the debt is settled in full. For example, a debtor is required to disclose specific information about TDRs that have occurred during the period for which financial statements are presented (see Section 11.5.2).

Unless a modification has been made to the debt terms, the debtor's failure to pay amounts when due or the creditor's delay in taking action to enforce the payment terms is not within the scope of ASC 470-60. However, the settlement of debt through a foreclosure or repossession or the transfer of assets or equity securities should be evaluated under ASC 470-60 even if the contractual terms are not modified (see Section 11.2.2 below). Special considerations are necessary for bankruptcy proceedings and quasi-reorganizations (see Section 11.2.3).

The following transactions are exempt from the scope of ASC 470-60:

- Lease modifications.
- Changes in employment-related contracts (e.g., pensions or deferred compensation arrangements).

ASC 470-60 does not address the creditor's accounting for TDRs. For such guidance, see ASC 310-40.

### 11.2.2 Foreclosures and Repossessions

<table>
<thead>
<tr>
<th>ASC 470-60</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-6 . . . Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term troubled debt restructuring in this Subtopic.</td>
</tr>
</tbody>
</table>

| 35-9 A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor or other transfer of assets to the creditor shall be accounted for according to the provisions of the preceding paragraph [ASC 470-60-35-8] and paragraphs 470-60-35-2 through 35-3. |

Debt that is satisfied through foreclosure, repossession, other transfer of the debtor's assets is not exempt from the scope of ASC 470-60 if it otherwise meets the criteria for a TDR (see Section 11.3). In practice, questions have arisen related to whether ASC 470-60 applies to foreclosures or repossessions of specified collateral (e.g., mortgaged property) if the creditor has no recourse to the debtor's other
assets. EITF Issue 91-2, which was not codified, discusses the applicability of ASC 470-60 to nonrecourse troubled debt that is fully satisfied by the transfer of underlying real estate collateral. It includes the following issue description:

The purchase of real property is often financed with nonrecourse debt. A loan is considered nonrecourse when the lender agrees, as part of the original loan negotiations, to accept only the real property being financed as security for the debt and cannot look to any other assets of the borrower to satisfy the loan.

The borrower may decide to transfer the property to the lender in full satisfaction of its obligation under the note. In that event, title to the property reverts to the lender, and the borrower has no further obligation to the lender.

For example, assume a company borrows $1,000 to purchase real property. The borrowing is nonrecourse. Several years later, the property has a fair value of $600, while the balance due to the lender is $800. The borrower decides to transfer the property to the lender in full satisfaction of the loan.

Although the EITF did not reach a consensus on Issue 91-2, the FASB staff and SEC staff indicated that ASC 470-60 applies in such a situation. They further suggested that a debtor should apply the two-step approach described in ASC 470-60-35-2 and 35-3 (see Section 11.4.2) in accounting for the satisfaction of the debt by the transfer of property. That is, Issue 91-2 states:

[T]he borrower would record a loss of $400 on the property, representing the decrease in the value from $1,000 to $600. The borrower also would record a gain on the extinguishment of debt of $200, representing the excess of the loan balance of $800 over the fair value of the property of $600.

### 11.2.3 Bankruptcy Proceedings and Quasi-Reorganizations

<table>
<thead>
<tr>
<th>ASC 470-60</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-10 The guidance in this Subtopic shall be applied to all troubled debt restructurings including those consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other federal statutes related thereto. This Subtopic does not apply, however, if under provisions of those federal statutes or in a quasi-reorganization or corporate readjustment (see Topic 852) with which a troubled debt restructuring coincides, the debtor restates its liabilities generally, that is, if such restructurings or modifications accomplished under purview of the bankruptcy court encompass most of the amount of the debtor's liabilities.</td>
</tr>
<tr>
<td>55-1 Entities involved with Chapter 11 bankruptcy proceedings frequently reduce all or most of their indebtedness with the approval of their creditors and the court in order to provide an opportunity for the entity to have a fresh start. Such reductions are usually by a stated percentage so that, for example, the debtor owes only 60 cents on the dollar. Because the debtor would be restating its liabilities generally, this Subtopic would not apply to the debtor's accounting for such reduction of liabilities.</td>
</tr>
<tr>
<td>55-2 On the other hand, this Subtopic would apply to an isolated troubled debt restructuring by a debtor involved in bankruptcy proceedings if such restructuring did not result in a general restatement of the debtor's liabilities.</td>
</tr>
</tbody>
</table>

ASC 470-60 does not apply to debt restructurings in which a debtor makes a general restatement of its liabilities in a reorganization under federal bankruptcy law or in conjunction with a quasi-reorganization. A quasi-reorganization is an accounting procedure by which an entity revalues its assets and liabilities on a “fresh-start” basis to their current fair value without undergoing a legal reorganization (see ASC 852). As noted in ASC 852-20-25-5, the “effective date of the readjustment . . . shall be as near as practicable to the date on which formal consent of the stockholders [to the reorganization] is given.” For example, a debt restructuring may be considered to have occurred in conjunction with a quasi-reorganization if each occurs within 30 days of the other.

If a debtor undergoing Chapter 11 bankruptcy proceedings obtains creditor and bankruptcy court approval for a reduction of substantially all of its liabilities, such a debt restructuring would be
considered a general restatement of its liabilities and consequently excluded from the scope of ASC 470-60. However, ASC 470-60 applies if a company negotiates debt restructurings on only some of its liabilities and does not generally restate its liabilities.

11.3 Determining Whether a Transaction Qualifies as a TDR

11.3.1 General

ASC Master Glossary

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.

In accordance with the definition of a TDR, (1) the debtor must be experiencing financial difficulties and (2) the creditor must grant the debtor a concession that it would not have considered in the absence of “economic or legal reasons related to the debtor’s financial difficulties.” In a TDR, a creditor accepts terms that it normally would not consider because it no longer expects to earn the rate of return anticipated at the time of initial investment. In other words, in the absence of the restructuring, the creditor would be paid a higher effective interest rate for the same receivable currently. For a TDR to exist, the debtor's creditworthiness must have deteriorated after the original issuance of the debt instrument and such deterioration must have compelled the creditor to accept terms that it would not otherwise consider.

ASC 470-60

55-4 No single characteristic or factor, taken alone, is determinative of whether a modification or exchange is a troubled debt restructuring under this Subtopic. That is, the fact that a single characteristic is present in a transaction (such as that described in paragraph 470-60-15-9(c)(3) or 470-60-15-12(d)) should not be considered sufficient to overcome the preponderance of contrary evidence. Determining whether a transaction is within the scope of this Subtopic requires the exercise of judgment. The guidance that follows is not limited to marketable debt instruments.

55-5 The following model should be applied by a debtor when determining whether a modification or an exchange of debt instruments is within the scope of this Subtopic.
ASC 470-60-15-9 (see Section 11.2.1) identifies characteristics or factors that may be present in a TDR, whereas ASC 470-60-15-8 and ASC 470-60-15-12 identify characteristics and factors that, if present, indicate that a debt restructuring is not necessarily a TDR even if the debtor is experiencing financial difficulties (see Section 11.3.2.2). No single characteristic or factor should be considered determinative of whether a debt restructuring is a TDR. The model described in ASC 470-60-55-5 through 55-14 must be applied to determine whether a debt modification or exchange is a TDR (see Section 11.3.2 [below] and Section 11.3.3.4). A debt modification or exchange that does not qualify as a TDR should be evaluated under ASC 470-50 (see Chapter 10).

11.3.2 Criterion 1 — The Debtor Is Experiencing Financial Difficulties

11.3.2.1 Indicators of Financial Difficulties

<table>
<thead>
<tr>
<th>ASC 470-60</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-7 If the debtor's creditworthiness (for example, based on its credit rating or equivalent, the effects of the original collateral or credit enhancements in the debt, or its sector risk) has deteriorated since the debt was originally issued, the debtor should evaluate whether it is experiencing financial difficulties. Changes in an investment-grade credit rating are not considered a deterioration in the debtor's creditworthiness for purposes of this guidance. Conversely, a decline in credit rating from investment grade to noninvestment grade is considered a deterioration in the debtor's creditworthiness for purposes of this guidance.</td>
</tr>
</tbody>
</table>
| 55-8 All of the following factors are indicators that the debtor is experiencing financial difficulties:
  a. The debtor is currently in default on any of its debt.
  b. The debtor has declared or is in the process of declaring bankruptcy.
  c. There is significant doubt as to whether the debtor will continue to be a going concern.
  d. Currently, the debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
  e. Based on estimates and projections that only encompass the current business capabilities, the debtor forecasts that its entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity.
  f. Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor. |

One of the two conditions in ASC 470-60 for TDR accounting is that the debtor must be experiencing financial difficulties. A debtor is required to evaluate whether it is experiencing financial difficulties if its creditworthiness has deteriorated since the debt was originally issued (i.e., the likelihood that it is unable to meet its debt obligations has increased). ASC 470-60 specifies that a change in credit rating from investment grade to noninvestment grade should be considered a deterioration in creditworthiness. However, a credit rating downgrade is not considered a deterioration in creditworthiness if the new credit rating is investment grade (e.g., the new credit rating is BBB or higher if issued by Standard and Poor's or Baa or higher if issued by Moody's). Other factors that may suggest that the debtor's creditworthiness has deteriorated include:

- A decline in the debtor's financial performance (e.g., recurring losses).
- A decline in the value of any collateral.
- Adverse changes in business, financial, or economic conditions (e.g., in the debtor's industry).
- Adverse changes in market indicators of the issuer's creditworthiness (e.g., credit spreads, credit default swap prices, or observable transactions in the debtor's securities).
The debtor should use judgment in determining whether, on the basis of the preponderance of the evidence, it is experiencing financial difficulties. The following factors are strong indicators that the debtor is experiencing financial difficulties:

- The debtor is experiencing current liquidity issues (i.e., insufficient cash flows to service its debt).
- The debtor forecasts that it will not have sufficient cash flows to pay the contractual principal and interest payments during the debt's remaining term.
- The debtor is generally unable to pay its debts when due.
- The debtor is unable to obtain new debt at terms applicable to nontroubled debtors from sources other than the current creditor.
- There is significant doubt related to whether the debtor will continue as a going concern.
- The debtor has declared or is in the process of declaring bankruptcy.
- The debtor's securities cease to meet exchange listing requirements because of financial issues.

**Example 11-1**

**Debtor That Is Experiencing Financial Difficulties**

Company A has defaulted on some of its debt and there is doubt related to whether it will be able to meet its debt obligations as they become due over the next 12 months. Company A concludes that it is experiencing financial difficulties.

If the debtor concludes that it is not experiencing financial difficulties, a debt restructuring is not a TDR. If the debtor is experiencing financial difficulties, it should evaluate whether it has received a concession before deciding whether the debt restructuring is a TDR (see Section 11.3.3).

### 11.3.2.2 Access to Alternative Funding

**ASC 470-60**

15-8 In general, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. A debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor in the troubled debt restructuring, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them.

d. The creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate.

c. The debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors.
Notwithstanding [ASC 470-60-55-8 and 55-9], the following factors, if both are present, provide determinative evidence that the debtor is not experiencing financial difficulties, and, thus, the modification or exchange is not within the scope of this Subtopic (the presence of either factor individually would be an indicator, but not determinative, that the debtor is not experiencing financial difficulty):

a. The debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a nontroubled debtor.

b. The creditors agree to restructure the old debt solely to reflect a decrease in current market interest rates for the debtor or positive changes in the creditworthiness of the debtor since the debt was originally issued.

A debtor that has access to alternative sources of funding from other creditors at a rate that is at or near the rates for nontroubled debt would not necessarily be experiencing financial difficulties even if its creditworthiness has deteriorated. Under ASC 470-60-55-9, a debtor is deemed not to be experiencing financial difficulties if the following two factors are present:

• “The debtor is [both (1)] currently servicing the old debt and [(2) able to] obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a nontroubled debtor.” In evaluating whether this condition is met, the debtor ignores any third-party debt that it was able to issue as a consequence of the debt restructuring. The debtor only considers debt that it would have been able to issue at a nontroubled borrowing rate in the absence of a debt restructuring.

• “The creditors agree to restructure the old debt solely to reflect [either (1)] a decrease in current market interest rates for the debtor or [(2)] positive changes in the creditworthiness of the debtor since the debt was originally issued.”

ASC 470-60-15-8 and ASC 470-60-15-12 should be applied in a manner consistent with ASC 470-60-55-5 through 55-14. For example, as noted in ASC 470-60-55-4, the transaction described in ASC 470-60-15-12(d) might be a TDR even if it involves the issuance of debt with an effective interest rate that is at or near the current market rates for nontroubled debt. The debtor should consider the factors in ASC 470-60-55-9 when evaluating such a transaction.

The January 4, 2002, meeting materials for the interpretive guidance in EITF Issue 02-4 (Issue Summary No. 1), which was subsequently codified in ASC 470-60, included two nonauthoritative examples, reproduced below, which illustrate the above guidance. The first example shows that a debt restructuring that involves a reduction in the effective borrowing rate (see Section 11.3.3.4.1) might not be a TDR in a scenario in which the debtor’s creditworthiness has not deteriorated and the debtor has access to alternative sources of funding from external sources at a rate that is at or near the rates for nontroubled debt even if the debtor anticipates some difficulties in meeting future principal and interest payments on the original debt. The second example shows that a debt restructuring that involves a reduction in the effective borrowing rate would be a TDR even if the restructured debt’s effective borrowing rate is based on a market price that is at or near the rates for nontroubled debt in a scenario in which the debtor is experiencing financial difficulties and does not have access to alternative sources of funding at a rate that is at or near the rates for nontroubled debt.
Chapter 11 — Troubled Debt Restructurings

Nonauthoritative EITF Meeting Materials

EITF Issue 02-4, Issue Summary 1 (January 4, 2002)

Example 1

Company A has publicly traded debt (old debt) outstanding. Company A is experiencing financial difficulties caused, in part, by the fact that its sales margins are decreasing while fixed costs have remained level. Based on current forecasts, Company A believes that it will have sufficient cash flows to service the old debt in accordance with its terms over the next six months, but may have difficulty making scheduled principal and interest payments beyond that point. The stated rate on the old debt is significantly higher than current market rates. To reduce costs, Company A renegotiated the terms of the old debt with its creditors and replaced it with new marketable debt (new debt).

Company A considered the following specific facts and circumstances:

- Company A initiated the restructuring to reduce the interest rate on its outstanding debt to a level more consistent with current market rates. At the reduced interest rate, Company A forecasts that its cash flows will be more than sufficient to service the debt in accordance with the revised terms, over both the near and longer term.
- The old debt's market price had increased since the date the debt was issued solely as a result of a decrease in general interest rates.
- Company A's credit rating has remained the same since the date it issued the old debt. That is, Company A concluded that the increase in the old debt's effective market rate was not due to a perceived increase in risk to the creditor.
- The new debt has the same payment dates, collateral requirements and covenant requirements as the old debt.
- The new debt has a lower principal amount and stated interest rate than the old debt. However, on the date of exchange, the new marketable debt has an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors.
- Company A was able to and considered borrowing funds from other sources at a lower interest rate than the old debt but decided that its best economic alternative was to renegotiate the debt with its current debt holders provided they agree to restructure the debt in ways more favorable to Company A.
- When Company A exchanged the new debt for the old debt with existing creditors, Company A issued an additional 20 percent of the par amount of the new debt at the same terms of the new debt to new investors. However, Company A could not have obtained those additional funds if the existing creditors did not agree to the terms of the restructuring.

Based on the above, even though there was a principal reduction in the old debt, Company A appropriately concluded sufficient persuasive evidence exists to support its assertion that economic and legal considerations related to its financial difficulty were not the primary reasons that compelled the creditors to restructure the marketable debt in ways more favorable to Company A. That is, the restructuring was not within the scope of [ASC 470-60].

While the following factors were also present, Company A did not consider them relevant to its conclusion:

- The market value of the old debt prior to the announcement of the terms of the restructuring was greater than the market value of the new debt.
- Eighty percent of the existing creditors at the date of the restructuring purchased the old debt within the past week, 10 percent purchased the old debt within the past month, while the remaining 10 percent were the original purchasers of the old debt.
Nonauthoritative EITF Meeting Materials (continued)

Example 2
Company B has publicly traded debt (old debt) outstanding. Company B is experiencing financial difficulties caused, in part, by the fact that its sales margins are decreasing while fixed costs have remained level. Based on current forecasts, Company B believes that it will not have sufficient cash flows to service the old debt in accordance with its terms in the near or long term. The stated rate on the old debt is significantly higher than current market rates. To reduce future cash flows, Company B renegotiated the terms of the old debt with its creditors and replaced it with new marketable debt (new debt).

Company B considered the following specific facts and circumstances:

- Company B's financial difficulties, which render it unable to service the debt over the near and long term, were the primary reason for its decision to renegotiate the terms of its debt in a manner that reduces both principal and interest.
- The old debt's market price had decreased since the date the debt was issued even though there was a decrease in general interest rates.
- Company B's credit rating has fallen below investment grade since the date it issued the old debt. That is, Company B concluded that the decrease in the old debt's market price was primarily due to a perceived increase in risk to the creditor.
- The new debt has the same payment dates, collateral requirements, and covenant requirements as the old debt.
- The new debt has a lower principal amount and stated interest rate than the old debt; however, on the date of exchange, the new marketable debt has an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors.
- Company B was not able to borrow funds from other sources at an effective interest rate that it could afford to pay. That is, Company B must rely on the current creditors to agree to restructure the old debt in ways more favorable to Company B in order for Company B to sustain operations.
- When Company B exchanged the new debt for the old debt with existing creditors, Company B issued an additional 20 percent of the par amount of the new debt at the same terms of the new debt to new investors. However, Company B could not have obtained those additional funds if the existing creditors did not agree to the terms of the restructuring.

Based on the above, even though the new debt has an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors, Company B appropriately concluded sufficient persuasive evidence exists to support its assertion that economic and legal considerations related to its financial difficulty were the primary reasons that compelled the creditors to restructure the marketable debt in ways more favorable to Company B. That is, the restructuring was within the scope of [ASC 470-60].

While the following factors were also present, Company B did not consider them relevant to its conclusion:

- The market value of the old debt prior to the announcement of the restructuring was equal to the market value of the new debt. That is, theoretically, Company B could have purchased the old debt from the existing creditors in the marketplace for an amount equal to the market value of the new debt.
- Eighty percent of the existing creditors at the date of the restructuring purchased the old debt within the past week, 10 percent purchased the old debt within the past month, while the remaining 10 percent were the original purchasers of the old debt.
11.3.3 **Criterion 2 — The Creditor Has Granted a Concession**

### 11.3.3.1 General

**ASC 470-60**

15-5 A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Subtopic 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.

15-6 That concession is granted by the creditor in an attempt to protect as much of its investment as possible. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court; for example, either of the following circumstances might occur:

a. A creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor.

b. The creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.

15-7 Whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it.

The second of the two conditions in ASC 470-60 for TDR accounting is that the creditor must have granted a concession. Such a concession might involve a reduction of the interest rate, forgiveness of principal or accrued interest, or a payment delay or deferral, and it could result from an agreement between the debtor and the creditor or be imposed by law or a court.

Although a concession involves making terms more favorable to the debtor, a creditor may have an economic incentive to grant a concession when a debtor is experiencing financial difficulties. For example, a concession may be in the creditor's economic best interest if it enables the debtor to avoid bankruptcy or other consequences of a default that could (1) have an adverse impact on the creditor's prospects of recovering amounts due from the debtor or (2) result in additional costs to the creditor (e.g., the legal costs of a foreclosure or bankruptcy proceeding). Paragraph 61 in the Basis for Conclusions of FASB Statement 15 states, in part:

> The description of a troubled debt restructuring . . . focuses on the economic and legal considerations related to the debtor's financial difficulties that in effect compel the creditor to restructure a receivable in ways more favorable to the debtor than the creditor would otherwise consider. The creditor participates in a troubled debt restructuring because it no longer expects its investment in the receivable to earn the rate of return expected at the time of investment and may view loss of all or part of the investment to be likely unless the receivable is restructured.

While the definition of a TDR suggests that the creditor must have granted a concession that it would not have considered if not for the debtor's financial difficulties, a debtor is not required to specifically evaluate whether the debtor's financial difficulties were the reason for the concession or whether the creditor would have granted the concession even if the debtor had not experienced financial difficulties.
11.3.3.2 Level of Aggregation

If a debtor has outstanding debt with multiple creditors, it should separately determine for each creditor whether a concession has been granted. If a debt arrangement involving multiple lenders is structured as a loan participation, the debtor has only one creditor (see Section 10.3.2.4).

If one creditor (or multiple creditors within a consolidated group or otherwise under common control) holds multiple debt instruments issued by the same debtor, the debtor should consider its total relationship with the creditor in determining whether a concession has been granted. For example, in assessing whether the effective borrowing rate on the restructured debt is below the effective borrowing rate immediately before the restructuring (see Section 11.3.3.4), the debtor would calculate and use a composite effective interest rate for any debt instruments that are evaluated on an aggregated basis. If it is determined that a concession has been granted, ASC 470-60-15-4 requires the debtor to apply the TDR accounting requirements to each payable individually (see Section 11.4.1.2).

11.3.3.3 Transfers of Assets or Issuances of Equity Interests

If a debt restructuring involves a transfer of assets or the issuance of an equity interest in full satisfaction of a debt obligation, the debtor should consider whether the fair value of those assets or equity interests equals or exceeds the debt's net carrying amount. The debtor has not received a concession if the fair value of those assets or equity interests equals or exceeds the debt's net carrying amount. Conversely, the debtor has received a concession if the debt's net carrying amount exceeds the fair value of such assets or equity interests.

Note that the transferred assets' carrying amount before the debt restructuring is not relevant in the determination of whether a concession has been granted. If a debtor transfers an asset that has a carrying amount of $100 to settle debt with a net carrying amount of $100, the creditor would be viewed as having granted a concession if the asset's fair value at the time of the debt restructuring is less than $100 (see also Section 11.4.2).

ASC 470-60 contains special accounting guidance for TDRs that involve a transfer of assets (see Section 11.4.2), a grant of equity interests (see Section 11.4.3), and a combination of the characteristics in ASC 470-60-15-9(a)-(c) (see Section 11.4.5).
11.3.3.4 **Debt Modifications and Exchanges**

11.3.3.4.1 **Effective Borrowing Rate Test**

<table>
<thead>
<tr>
<th>ASC 470-60</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-10</strong> A creditor is deemed to have granted a concession if the debtor’s effective borrowing rate on the restructured debt is less than the effective borrowing rate of the old debt immediately before the restructuring. The effective borrowing rate of the restructured debt (after giving effect to all the terms of the restructured debt including any new or revised options or warrants, any new or revised guarantees or letters of credit, and so forth) should be calculated by projecting all the cash flows under the new terms and solving for the discount rate that equates the present value of the cash flows under the new terms to the debtor’s current carrying amount of the old debt.</td>
</tr>
<tr>
<td><strong>55-11</strong> The carrying amount for purposes of this test would not include any hedging effects (including basis adjustments to the old debt) but would include any unamortized premium, discount, issuance costs, accrued interest payable, and so forth.</td>
</tr>
<tr>
<td><strong>55-12</strong> When determining the effect of any new or revised sweeteners (options, warrants, guarantees, letters of credit, and so forth), the current fair value of the new sweetener or change in fair value of the revised sweetener would be included in day-one cash flows. If such sweeteners are not exercisable for a period of time, that delay is typically considered within the estimation of the initial fair value as of the debt’s modification date.</td>
</tr>
</tbody>
</table>

If existing debt is modified or exchanged for new debt, the debtor is deemed to have received a concession if the effective borrowing rate on the restructured debt is less than the effective borrowing rate immediately before the restructuring. However, a reduction in the effective borrowing rate is not considered a concession if there is persuasive evidence that it is due solely to a factor that is not reflected in the calculation of the effective borrowing rate (see Section 11.3.3.4.2).

A debtor calculates the effective borrowing rate on the modified debt by solving for the discount rate that equates the future cash flows of the modified debt to the current net carrying amount of the original debt. In this calculation, the net carrying amount excludes any hedge accounting adjustments (e.g., if the debt was designated as a hedged item in a fair value hedge under ASC 815; see Section 14.2.1.2) but reflects any remaining unamortized premium or discount (see Chapter 5) as well as any accrued interest payable.

All terms of the restructured debt must be considered in the determination of the cash flows of the restructured debt. If the debt restructuring includes any new “sweetener” (e.g., warrant, option, guarantee, or letter of credit) issued by the debtor, its fair value is treated as an immediate cash outflow as of the time of the debt restructuring (i.e., as a “day 1 cash outflow”). Similarly, the change in fair value of any amended sweeteners as a result of the modification (i.e., the fair value of the sweetener immediately before the debt restructuring compared with its fair value immediately after the modification) is treated as a day 1 cash flow. However, in evaluating whether a concession has been made, the debtor does not compare the fair value of the restructured debt with the fair value of the original debt at the time of the debt restructuring.

ASC 470-60-15-9 contains special accounting guidance for TDRs that involve a debt modification or exchange (see Section 11.4.4) or a combination of the characteristics specified in that guidance (see Section 11.4.5).
Example 11-2

**Increase in Interest Rate Does Not Involve a Concession**

Company P is in violation of its debt covenants. Although P’s revolver has been amended several times in the past year, resulting in an increase of 100 basis points in the interest rate, the amendments have not provided for either a reduction or forgiveness of the outstanding obligation (principal and interest). The amendments include “stand-still” agreements, which generally state that the banks will not force P into bankruptcy as long as it makes monthly interest payments and periodic principal payments despite its failure to meet the debt covenants. In the absence of the stand-still agreements, the debt would have become currently due.

The amendments to P’s debt do not constitute a TDR but rather an increase in interest rates, and they have not resulted in a reduced principal or accrued interest balance. In addition, P has not granted an equity interest to its creditors nor has it transferred title to any of its assets to its creditors in satisfaction of any of the outstanding debt. Therefore, the creditor has not granted P a concession, and the amendments to P’s debt do not result in a TDR.

Example 11-3

**Amendment to Debt Covenant Ratio Does Not Involve a Concession**

Company S has been experiencing financial difficulties and announced that it would be unable to make the required interest payment to Lender H for the month of December. The terms of the debt agreement provide for a 30-day grace period for paying the interest. In December, S amended its credit agreement with H and reduced the fixed-charge coverage ratio requirement from 1.25 to 1.05 for its fourth-quarter debt covenant calculation. Company S paid $1.3 million to H to obtain this waiver. In January, S was able to refinance the debt with a different creditor on substantially similar terms and made the required interest payments within the 30-day grace period.

In these circumstances, the amendment to the debt covenant ratio does not represent a concession on the part of H. As a result of the cash payment required on the date of the fixed-charge ratio waiver, H has increased its effective interest rate. In addition, S was able to obtain new financing after year-end on substantially similar terms. ASC 470-50-40-18 addresses the treatment of fees paid to third parties in the event of a modification or exchange of a debt instrument in a nontroubled debt situation.

Example 11-4

**Change in Effective Rate on Debt — Concession Has Been Granted**

On December 31, 20X0, Entity D issues five-year debt for net proceeds of $245,000. The face amount is $250,000. The stated interest rate is 5 percent per annum payable annually in arrears. The effective interest rate is 5.47 percent per annum. The original amortization schedule is shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Discount Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X0</td>
<td>$ (245,000)</td>
<td></td>
<td></td>
<td>$ 245,000.00</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>12,500</td>
<td>$13,396.46</td>
<td>$896.46</td>
<td>245,896.46</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>12,500</td>
<td>13,445.47</td>
<td>945.47</td>
<td>246,841.93</td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>12,500</td>
<td>13,497.17</td>
<td>997.17</td>
<td>247,839.10</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>12,500</td>
<td>13,551.70</td>
<td>1,051.70</td>
<td>248,890.80</td>
</tr>
<tr>
<td>12/31/20X5</td>
<td>262,500</td>
<td>13,609.20</td>
<td>1,109.20</td>
<td>—</td>
</tr>
</tbody>
</table>
Example 11-4 (continued)

On December 31, 20X1, D is experiencing financial difficulties and negotiates a debt restructuring with its creditor. The new stated interest rate is 7 percent per annum (i.e., the stated rate has increased), and the new face amount is $210,000 (i.e., the creditor has forgiven $40,000 of principal). In addition, D issues a warrant with a fair value of $10,000 to the creditor.

To determine whether the creditor has granted a concession, D computes the new effective borrowing rate. It treats the fair value of the warrants issued as an immediate cash outflow to pay down a portion of the outstanding balance (i.e., as an immediate reduction in the net carrying amount). Because the new effective borrowing rate (3.63 percent per annum) is lower than the original effective borrowing rate, D is deemed to have received a concession and applies TDR accounting to the debt restructuring.

Example 11-5

Change in Effective Borrowing Rate — Concession Has Not Been Granted

On December 31, 20X0, Entity T issues a five-year debt security for net proceeds of $97,000. The principal amount is $100,000, and the stated coupon rate is 8 percent payable annually in arrears. Because the debt security was issued at a discount, its stated interest rate differs from its effective interest rate. By solving for the rate that equates the initial net proceeds to the future contractual interest and principal cash flows, T determines that the annual effective interest rate equals 8.77 percent. The original discount amortization schedule is shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Discount Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X0</td>
<td>(97,000)</td>
<td></td>
<td></td>
<td>97,000.00</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>8,000</td>
<td>$ 8,503.61</td>
<td>$ 503.61</td>
<td>97,503.61</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>8,000</td>
<td>$ 8,547.77</td>
<td>547.77</td>
<td>98,051.38</td>
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<tr>
<td>12/31/20X3</td>
<td>8,000</td>
<td>$ 8,595.78</td>
<td>595.78</td>
<td>98,647.16</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>8,000</td>
<td>$ 8,648.02</td>
<td>648.02</td>
<td>99,295.18</td>
</tr>
<tr>
<td>12/31/20X5</td>
<td>108,000</td>
<td>$ 8,704.82</td>
<td>704.82</td>
<td>—</td>
</tr>
</tbody>
</table>

In late 20X2, T is experiencing financial difficulties and negotiates a debt restructuring with the lender. On January 1, 20X3, the lender agrees to forgive $4,000 of principal and reduces the stated coupon rate to 4 percent per annum. In addition, P delivers warrants with a fair value of $5 to the holder.

In evaluating whether there is a concession, T should calculate the effective borrowing rate of the restructured debt. Entity T solves for the discount rate that equates the contractual cash flows of the modified debt (including the fair value of the warrant) to the current net carrying amount of the original debt ($98,051.38). It treats the fair value of the warrants as an immediate cash outflow. Entity T determines that the revised annual effective borrowing rate is 5.13 percent. Because the original effective borrowing rate exceeds the revised effective borrowing rate, the lender has granted a concession. Since T is experiencing financial difficulties, the debt restructuring is a TDR.
11.3.3.4.2 Decrease in Effective Borrowing Rate Due to Other Factors

_**ASC 470-60**_

**55-13** Although considered rare, if there is persuasive evidence that the decrease in the effective borrowing rate is due solely to a factor that is not captured in the mathematical calculation (for example, additional collateral), the creditor may not have granted a concession and the modification or exchange should be evaluated based on the substance of the modification.

While a decrease in the debt's effective borrowing rate generally represents a concession under ASC 470-60 (see Section 11.3.3.4.1), ASC 470-60-55-13 provides an exception for scenarios in which persuasive evidence exists that the reduction is due solely to a factor that is not reflected in the calculation of the effective borrowing rate. For example, a reduction in the effective borrowing rate that results from the posting of additional collateral that justifies the reduction in rate is not treated as a concession. However, ASC 470-60-55-13 notes that it would be rare to conclude that a reduction in the effective borrowing rate is not a concession.

ASC 470-60-15-12 specifies that TDR accounting does not apply when the interest rate on the debt is reduced to reflect a general decrease in market interest rates or an improvement in the debtor's creditworthiness as long as the debtor is currently servicing the original debt and can obtain funds from other sources at rates at or near those for nontroubled debt (see Section 11.3.2.2). The fact that the debtor can readily obtain funds from other sources at or near the current market interest rates for nontroubled debtors suggests that the debtor should not be viewed as experiencing financial difficulties.

11.3.3.4.3 Consecutive Restructurings

_**ASC 470-60**_

**55-14** Notwithstanding the guidance in this Section, if an entity has recently restructured the debt and is currently restructuring that debt again, the effective borrowing rate of the restructured debt (after giving effect to all the terms of the restructured debt including any new or revised options or warrants, any new or revised guarantees or letters of credit, and so forth) should be calculated by projecting all the cash flows under the new terms and solving for the discount rate that equates the present value of the cash flows under the new terms to the debtor's previous carrying amount of the debt immediately preceding the earlier restructuring. In addition, the effective borrowing rate of the restructured debt should be compared with the effective borrowing rate of the debt immediately preceding the earlier restructuring for purposes of determining whether the creditor granted a concession (that is, whether the effective borrowing rate decreased).

If a debtor restructures the same debt multiple times in a short period, those debt restructurings are evaluated on a cumulative basis. That is, the debtor calculates the effective borrowing rate of the restructured debt (see Section 11.3.3.4.1) on the basis of (1) the net carrying amount before the first recent modification (rather than the net carrying amount after the most recent modification) and (2) the modified cash flows after the most recent modification. In determining whether the creditor has granted a concession, the debtor compares the effective borrowing rate of the debt before the first recent modification with the effective borrowing rate of the restructured debt. ASC 470-60 does not specifically address what would be considered a “recent” modification. Unless the facts and circumstances suggest that a different time frame should apply, a debtor may analogize to the one-year time frame that applies to debt modifications under ASC 470-50 (see Section 10.3.3.4).
11.3.4 Factors That Do Not Affect the Evaluation

ASC 470-60

The following factors have no relevance in the determination of whether a modification or an exchange is within the scope of this Subtopic:

a. The amount invested in the old debt by the current creditors
b. The fair value of the old debt immediately before the modification or exchange compared to the fair value of the new debt at issuance
c. Transactions among debt holders.

In addition, the length of time the current creditors have held the investment in the old debt is not relevant in the determination of whether a modification or exchange is within the scope of this Subtopic unless all the current creditors recently acquired the debt from the previous debt holders to effect what is in substance a planned refinancing.

In accordance with ASC 470-60, the following factors are not relevant in the evaluation of whether a debt restructuring is a TDR:

• The amount that current creditors have invested in the debt. For example, the fact that an investor may have purchased the debt from another investor at a discount to par does not affect the analysis of whether that investor has granted a concession or the debtor is experiencing financial difficulties.

• The fair value of the restructured debt relative to the fair value of the original debt at the time of the debt restructuring. Note, however, that the fair value of any consideration transferred (such as assets or equity interests) in full or partial satisfaction of the debt is relevant to the analysis (see Section 11.3.3.3).

• Transactions among debt holders to which the debtor is not a party (see Section 10.2.8). For example, the fact that the debt may be purchased at a deep discount to par in market transactions between third parties does not affect whether TDR accounting applies.

• The length of time during which creditors have held the debt (unless they acquired it recently for a planned refinancing).

Although transactions among debt holders do not trigger TDR accounting, any debt modification or exchange that involves the debtor or its agent should be evaluated in the determination of whether TDR accounting applies even if the modification is made in connection with a transfer to a new holder (see Section 10.2.8 for analogous guidance).

Connecting the Dots

Because the guidance for the debtor in ASC 470-60 differs from the guidance for the creditor in ASC 310-40, a debtor may conclude that a modification is a TDR even if the creditor does not treat it in such a manner. See Section 11.3.5.

Example 11-6

Modification After a Creditor’s Sale of Debt

Company T is experiencing financial difficulties and expects to renegotiate its outstanding loan with Bank A. Bank A would like to end its relationship with T; therefore, A sells its loan receivable to Bank B. Shortly after this sale, T modifies the terms of the loan with B by reducing the principal amount owed. In this example, the debtor is experiencing financial difficulties and a concession has been granted. Therefore, the modification is within the scope of ASC 470-60 even though the modification involves a new creditor.
If the debtor has involved an intermediary (e.g., a bank) to transact with its debt holders, the debtor should evaluate whether the intermediary acts as a principal in its own capacity or as the debtor’s agent (see Section 10.5). Transactions made by an intermediary as the debtor’s agent are treated as transactions made by the debtor itself.

### 11.3.5 Relationship to Creditor’s Assessment

**ASC 470-60**

15-3 This Subtopic establishes standards of financial accounting and reporting by the debtor for a troubled debt restructuring. Subtopic 310-40 addresses a creditor’s financial accounting and reporting for a troubled debt restructuring. Together, the two Subtopics establish tests for applicability that are not symmetrical between the debtor and the creditor if the debtor’s carrying amount and the creditor’s recorded investment differ. A debtor may have a troubled debt restructuring under this Subtopic even though the related creditor does not have a troubled debt restructuring under the same tests in Subtopic 310-40. The debtor and creditor shall individually apply the tests to the specific facts and circumstances to determine whether a troubled debt restructuring has occurred. The guidance in paragraphs 470-60-15-5 through 15-13 establishes whether a troubled debt restructuring has occurred from the debtor’s perspective.

**Pending Content (Transition Guidance: ASC 326-10-65-1)**

15-3 This Subtopic establishes standards of financial accounting and reporting by the debtor for a troubled debt restructuring. Subtopic 310-40 addresses a creditor’s financial accounting and reporting for a troubled debt restructuring. Together, the two Subtopics establish tests for applicability that are not symmetrical between the debtor and the creditor if the debtor’s carrying amount and the creditor’s amortized cost basis differ. A debtor may have a troubled debt restructuring under this Subtopic even though the related creditor does not have a troubled debt restructuring under the same tests in Subtopic 310-40. The debtor and creditor shall individually apply the tests to the specific facts and circumstances to determine whether a troubled debt restructuring has occurred. The guidance in paragraphs 470-60-15-5 through 15-13 establishes whether a troubled debt restructuring has occurred from the debtor’s perspective.

15-12 A debt restructuring is not necessarily a troubled debt restructuring for purposes of this Subtopic even if the debtor is experiencing some financial difficulties. For example, a troubled debt restructuring is not involved if any of the following circumstances exist:

a. The fair value of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor’s recorded investment in the receivable. . . .

**Pending Content (Transition Guidance: ASC 326-10-65-1)**

15-12 A debt restructuring is not necessarily a troubled debt restructuring for purposes of this Subtopic even if the debtor is experiencing some financial difficulties. For example, a troubled debt restructuring is not involved if any of the following circumstances exist:

a. The fair value of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor’s amortized cost basis in the receivable. . . .

55-15 Paragraph 470-60-15-3 explains that a debtor may have a troubled debt restructuring under this Subtopic even though the related creditor does not have a troubled debt restructuring under the same tests in this Subtopic. Paragraph 470-60-15-3 refers to the tests the debtor and creditor must individually apply to the specific facts and circumstances to determine whether a troubled debt restructuring has occurred. For implementation guidance, see paragraph 310-40-55-4.
A debtor may have a TDR even if the related creditor does not have a TDR on the same restructured debt under ASC 310-40. This is because debtors and creditors perform different tests to evaluate whether a TDR exists (e.g., whether a debtor’s transfer of assets or equity interests qualify as a TDR).

11.4 Accounting

11.4.1 General

11.4.1.1 Background

ASC 470-60

10-1 The accounting for restructured debt is based on the substance of the modifications — the effect on cash flows — not on the labels chosen to describe those cash flows. The substance of all modifications of a debt in a troubled debt restructuring is essentially the same whether they involve modifications of any of the following:

   a. Timing
   b. Amounts designated as interest
   c. Amounts designated as face amounts.

10-2 All of those kinds of modifications affect future cash receipts or payments and therefore affect both of the following:

   a. The creditor’s total return on the receivable, its effective interest rate, or both
   b. The debtor’s total cost on the payable, its effective interest rate, or both.

35-1 A debtor shall account for a troubled debt restructuring according to the type of the restructuring as prescribed in this Section.

The accounting for a TDR depends on whether it involves a transfer of assets, the grant of an equity interest, a modification of the debt terms, or a combination thereof:

• **Transfer of assets** (see Sections 11.4.2 and 11.4.5) — The debtor transfers trade receivables, real estate, or other assets to the creditor to fully or partially satisfy outstanding debt.

• **Grant of equity interest** (see Sections 11.4.3 and 11.4.5) — The debtor issues an equity interest (e.g., the issuer’s common or preferred stock) to the creditor to fully or partially satisfy outstanding debt.

• **Modification of the debt terms** (see Section 11.4.4) — For example:

   ◦ A reduction of the stated interest rate.
   ◦ A reduction of the principal amount of the debt.
   ◦ An extension of maturity dates.
   ◦ A forgiveness or reduction of the amount of accrued interest due.
   ◦ A payment deferral.

If a TDR involves a transfer of assets, any difference between the fair value (under ASC 820) and carrying amount of the transferred assets at the time of the restructuring is reflected as a gain or loss in the same manner as if the assets were sold for cash. If a TDR involves a grant of an equity interest, the equity securities are initially recognized at fair value in accordance with ASC 820 at the time of the restructuring. As noted in paragraph 77 of the Basis for Conclusions of FASB Statement 15, the Board concluded that such transactions should be accounted for at fair value because the transfer of assets or
grant of equity interests is accounted for at fair value under a transaction-based accounting framework. However, if a TDR involves a modification of debt terms, it is accounted for only prospectively unless the carrying amount exceeds the undiscounted total amount of future cash payments.

### 11.4.1.2 Unit of Account

**ASC 470-60**

15-4 The substance rather than the form of the payable shall govern. . . . Typically, each payable is negotiated separately, but sometimes two or more payables are negotiated together. For example, a debtor may negotiate with a group of creditors but sign separate debt instruments with each creditor. For purposes of this Subtopic, restructuring of each payable, including those negotiated and restructured jointly, shall be accounted for individually.

55-3 To a debtor, a bond constitutes one payable even though there are many bondholders.

If an entity determines that a debt restructuring should be accounted for as a TDR, it applies the TDR accounting requirements in ASC 470-60 separately to each unit of account (see Section 3.3) even if multiple debt instruments have identical terms or are restructured at the same time.

**Example 11-7**

**Debt Owned by Multiple Creditors**

Company R has subordinated debentures that are held by a significant shareholder, a major insurance company, and other parties. Company R is experiencing financial difficulties and has negotiated with the shareholder and the major insurance company to redeem the debentures for senior indebtedness and a combination of preferred and common stock of R. In addition, R has offered the other parties a package of preferred stock and cash in exchange for their subordinated debentures.

The TDR accounting requirements of ASC 470-60 should be applied to each individual transaction (or group of creditors) rather than in the aggregate because each group separately negotiated its restructuring. In substance, there are three creditor groups. If a company presents a restructuring plan to holders of debt securities and a portion of the debt holders accept the plan, the company should account for the bonds as TDRs to the extent of the participation in the exchange offer. Accordingly, the TDR accounting requirements of ASC 470-60 should be applied only to the portion of the bonds that are actually restructured. The accounting for the bonds owned by bondholders that do not participate in the restructuring is not affected.

### 11.4.1.3 Time of Restructuring

**ASC Master Glossary**

**Time of Restructuring**

Troubled debt restructurings may occur before, at, or after the stated maturity of debt, and time may elapse between the agreement, court order, and so forth, and the transfer of assets or equity interest, the effective date of new terms, or the occurrence of another event that constitutes consummation of the restructuring. The date of consummation is the time of the restructuring.

A TDR should be recognized in the period in which it occurs (i.e., at the time of the debt restructuring). The time of the restructuring is the date of its consummation (e.g., the date on which any assets or equity interests are transferred in settlement of the debt, or new debt terms become legally binding). A debtor should not recognize a gain on restructuring before consummation of the restructuring.
If an entity restructures debt after its balance sheet date but before issuing its financial statements, that restructuring is a nonrecognized subsequent event under ASC 855. However, the debtor is required to consider whether the restructuring is of such a nature that it must be disclosed to keep the financial statements from being misleading (see ASC 855-10-50-2).

**Example 11-8**

**Debt Modification That Is Consummated After the Balance Sheet Date**

Entity C has $120 million of notes outstanding. On October 31, 20X1, C defaulted on an interest payment due under the debt and entered into negotiations with the noteholders to restructure the debt. On December 1, 20X1, the noteholders agreed to exchange their existing notes for new notes through an exchange offer to be completed before February 28, 20X2. The noteholders had a choice of receiving new notes or a combination of new notes and cash. The agreement stipulated certain steps that C was to take before the exchange offer could take place (e.g., renewal of a line of credit, sale of a division for cash). On December 31, 20X1, no legal documentation had been finalized for the restructuring; the agreement was therefore not binding. On February 8, 20X2, the choices of all noteholders had been received and the exchange offer document was finalized.

Because the actual debt restructuring occurred after December 31, 20X1, and was not legally binding on December 31, 20X1, the transaction should be treated as a nonrecognized subsequent event and recognized in the first quarter of 20X2. Accordingly, interest should be accrued as of December 31, 20X1, on the basis of the terms of the original debt agreements.

11.4.1.4 Costs and Fees

**ASC 470-60**

**35-12** Legal fees and other direct costs that a debtor incurs in granting an equity interest to a creditor in a troubled debt restructuring shall reduce the amount otherwise recorded for that equity interest according to paragraphs 470-60-35-4 and 470-60-35-8. All other direct costs that a debtor incurs to effect a troubled debt restructuring shall be deducted in measuring gain on restructuring of payables or shall be included in expense for the period if no gain on restructuring is recognized.

The accounting for any costs and fees incurred in connection with a TDR depends on whether they are attributable to an equity interest granted. Legal fees and other direct costs of issuing an equity interest (e.g., common or preferred stock) reduce the initial carrying amount of the equity interest issued. Other costs incurred in a TDR (e.g., a TDR that involves the transfer of assets or a debt modification or exchange) reduce any restructuring gain recognized (see Section 11.4.4) or, if there is no gain, are expensed in the period incurred. If the TDR represents a combination of the characteristics in ASC 470-60-15-9(a)–(c), a debtor should use a reasonable method to allocate fees and costs between equity interests granted and the restructuring gain or expenses (e.g., by specifically identifying such costs).

Costs incurred related to a potential restructuring that has not been completed as of the balance sheet date may not be deferred and recognized as an asset.

ASC 470-60-35-12 does not apply to any remaining unamortized debt issuance costs at the time of the restructuring; such costs are part of the debt’s net carrying amount immediately before the restructuring. Accordingly, if the total amount of future undiscounted cash flows of the restructured debt exceeds the net carrying amount, such costs continue to be amortized after the TDR (see Section 11.4.4.2). Alternatively, if the TDR involves the recognition of a restructuring gain, any remaining unamortized debt issuance costs reduce the amount of the gain that would otherwise have been recognized (see Section 11.4.4.3).
11.4.1.5 Related-Party Transactions

There is no scope exception in ASC 470-60 for debt restructurings with related parties. ASC 470-60 does not distinguish between debt with outside entities and debt with related parties (see ASC 850). While the fact that a creditor is a significant shareholder affects the accounting for any potential gains from the debt modifications (i.e., such gains are treated as capital contributions by analogy to ASC 470-50-40-2; see Section 9.3.7.2), a debtor must still consider whether a TDR has occurred.

Example 11-9

TDR Involving a Related Party

To meet future needs for debt service, operations support, and capital outlay, Company N negotiated a restructuring with its preferred stockholders, subordinated debt holders, and bank debt holders. As part of the restructuring, the aggregated outstanding principal amount of the subordinated debt was converted into shares of common stock. The value provided to the debt holders in the form of the common stock was substantially less than the carrying amount of the subordinated debt before the exchange. The subordinated debt holders also had significant investments in preferred stock of N.

By analogy to ASC 470-50-40-2 (see Section 9.3.7.2), forgiveness of the amounts owed to a significant shareholder should be accounted for as a capital contribution to the debtor to the extent that the carrying amount of the payable on the date of the restructuring exceeds either (1) the total future cash payments that will be made to the shareholder under the new terms or (2) the fair value of the assets transferred or the equity interest granted. Accordingly, N should recognize the “restructuring gain” realized from the forgiveness of amounts owed as an equity capital contribution.

11.4.2 Accounting for Transfer of Assets in Full Settlement of Troubled Debt

According to ASC 470-60, a debtor that transfers its receivables from third parties, real estate, or other assets to a creditor to settle fully a payable shall recognize a gain on restructuring of payables. The gain shall be measured by the excess of the carrying amount of the payable over the fair value of the assets transferred to the creditor. However, while the guidance in this Subtopic indicates that the fair value of assets transferred or the fair value of an equity interest granted shall be used in accounting for a settlement of a payable in a troubled debt restructuring, that guidance is not intended to preclude using the fair value of the payable settled if more clearly evident than the fair value of the assets transferred or of the equity interest granted in a full settlement of a payable. However, in a partial settlement of a payable, the fair value of the assets transferred or of the equity interest granted shall be used in all cases to avoid the need to allocate the fair value of the payable between the part settled and the part still outstanding.

A difference between the fair value and the carrying amount of assets transferred to a creditor to settle a payable is a gain or loss on transfer of assets. The carrying amount of a receivable encompasses not only unamortized premium, discount, acquisition costs, and the like but also an allowance for uncollectible amounts and other valuation accounts, if any. The debtor shall include that gain or loss in measuring net income for the period of transfer, reported as provided in Topic 220. A loss on transferring receivables to creditors may therefore have been wholly or partially recognized in measuring net income before the transfer and be wholly or partly a reduction of a valuation account rather than a gain or loss in measuring net income for the period of the transfer.

If a debtor pays cash to settle troubled debt in full, it recognizes a restructuring gain to the extent that the net carrying amount exceeds the amount of cash paid. ASC 470-60 requires a debtor to apply a “two-step” approach in accounting for a TDR involving a transfer of noncash assets (including a
repossession or foreclosure of assets; see Section 11.2.2). That is, when a debtor transfers a noncash asset in full settlement of a debt, any resulting gain or loss consists of two separate components:

1. The difference, if any, between the fair value and carrying amount of the asset transferred is recognized as a gain or loss upon derecognition of the asset transferred. (If an issuer transfers assets in full settlement of a payable, ASC 470-60-35-2 does not preclude the debtor from calculating this gain or loss on the basis of the fair value of the payable settled instead of the fair value of the assets transferred if the fair value of the payable settled is more clearly evident.)

2. The difference, if any, between that fair value and the carrying amount of the debt is recognized as a restructuring gain on the debt that is settled.

A “one-step” approach is not appropriate. Under such a method, a restructuring gain or loss would be recognized for the net difference between the carrying amount of the asset transferred and the carrying amount of the payable settled.

For TDRs that occurred during a reporting period,ASC 470-60-50-1 requires separate disclosure, either on the face of the financial statements or in the accompanying notes, of (1) the aggregate net gain or loss on asset transfers recognized during the period and (2) the aggregate gain on restructuring of payables (see Section 11.5.2).

**Example 11-10**

**Accounting for a Transfer of Financial Assets in Full Settlement of a Payable**

Company A is experiencing financial difficulties and agrees to settle its $125 million of debt to Creditor C in full by transferring fixed-rate loan receivables that have a net carrying amount of $130 million. Company A estimates the current fair value of the receivables to be $110 million.

Even though the net carrying amount of the assets transferred exceeds the net carrying amount of the debt settled, A would recognize a restructuring gain of $15 million to reflect the difference between the fair value of the assets transferred to settle the debt and the net carrying amount of the debt settled. Further, it would recognize a loss on the asset transfer of $20 million.

**Example 11-11**

**Accounting for a Transfer of Nonfinancial Assets in Full Settlement of a Payable**

Company S is experiencing financial difficulties and will not be able to make the scheduled payments on its outstanding note to Company T. Company S has reached an agreement with T under which S will transfer land to T to fully settle the outstanding obligation. The land has a book value of $90,000 and a fair value of $100,000. The outstanding note has a principal balance of $100,000 and related accrued interest of $5,000. Company S would record the following entry related to the settlement:

**Journal Entry**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable</td>
<td>100,000</td>
</tr>
<tr>
<td>Interest payable</td>
<td>5,000</td>
</tr>
<tr>
<td>Land</td>
<td>90,000</td>
</tr>
<tr>
<td>Gain on transfer of assets (fair value of $100,000 less book value of $90,000)</td>
<td>10,000</td>
</tr>
<tr>
<td>Gain on settlement of debt and interest accrued (book value of $105,000 less fair value of $100,000)</td>
<td>5,000</td>
</tr>
</tbody>
</table>

To record the transfer of assets in full settlement of payable.
Example 11-12

Accounting for a Foreclosure of Collateral in Full Settlement of a Payable

Company T, whose fiscal year ends on December 31, owns a mall that is subject to nonrecourse debt. The fair value of the mall is significantly less than the amount of related debt (due November 1, 20X4) and the carrying amount of the mall. Although T is currently negotiating with the lender, T believes that it will most likely allow the bank to foreclose on the property, in which case it will realize a gain on extinguishment of debt. Consequently, T believes that it will not be able to recover the carrying amount of the asset and that it should therefore recognize a loss on impairment. Company T would prefer not to record an impairment loss on the property in its third quarter but rather recognize a gain on extinguishment of debt in its fourth quarter.

Company T cannot defer recognition of the impairment loss until its fourth quarter and net the loss with the anticipated gain on the extinguishment of debt. ASC 360-10-35-15 through 35-49 require an entity to measure an impairment loss for a long-lived asset, including an asset that is subject to nonrecourse debt, as the amount by which the carrying amount of the asset (asset group) exceeds its fair value. The recognition of an impairment loss and the recognition of a gain on the extinguishment of debt are separate events, and each event should be recognized in the period in which it occurs. The recognition of an impairment loss should be based on the measurement of the asset at its fair value; the existence of nonrecourse debt should not influence that measurement.

11.4.3 Accounting for Grant of Equity Interest in Full Settlement of Troubled Debt

<table>
<thead>
<tr>
<th>ASC 470-60</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-4</strong> A debtor that issues or otherwise grants an equity interest to a creditor to settle fully a payable shall account for the equity interest at its fair value. The difference between the fair value of the equity interest granted and the carrying amount of the payable settled shall be recognized as a gain on restructuring of payables.</td>
</tr>
<tr>
<td><strong>35-12</strong> Legal fees and other direct costs that a debtor incurs in granting an equity interest to a creditor in a troubled debt restructuring shall reduce the amount otherwise recorded for that equity interest according to paragraphs 470-60-35-4 and 470-60-35-8. . . .</td>
</tr>
</tbody>
</table>

When a debtor grants an equity interest (e.g., common or preferred stock or warrants that qualify for classification in equity) in full settlement of debt in a TDR, multiple financial statement accounts are affected:

- The debtor recognizes an increase in shareholders’ equity for the fair value of the equity interests issued less legal fees and other direct issuance costs (see Section 11.4.1.4). (If an issuer grants equity interests in full settlement of a payable, it is permitted to elect to measure the equity interests issued on the basis of the fair value of the payable settled instead of the fair value of the equity interests issued if the fair value of the payable settled is more clearly evident; see ASC 470-60-35-2.)
- The difference, if any, between that fair value and the carrying amount of the debt is recognized as a restructuring gain on the debt that is settled.

The FASB has rejected approaches that would have involved including the restructuring gain in equity or increasing equity for the carrying amount of the payable settled with no gain recognized.
Example 11-13

**Accounting for a Transfer of Equity Shares in Full Settlement of a Payable**

Entity E is experiencing financial difficulties. It agrees with creditors to settle outstanding nonconvertible debt with a net carrying amount of $45 million in full by issuing 10 million shares of common stock, which have an aggregate fair value of $25 million at the time of the restructuring (i.e., $2.50 per share). Accordingly, E recognizes a restructuring gain of $20 million.

ASC 470-60 does not specifically address how to account for the issuance of a liability-classified financial instrument in the form of a share (e.g., a mandatorily redeemable financial instrument) in settlement of debt under ASC 470-60. If a debtor issues a mandatorily redeemable financial instrument in the form of a share that must be classified as a liability under ASC 480-10-25-4, the issuer should not account for it as a grant of an equity interest under ASC 470-60 but as a troubled debt modification or exchange (see Section 11.4.4 below).

Example 11-14

**Accounting for a Transfer of Liability-Classified Shares in Full Settlement of a Payable**

Company G has restructured its debt because of its inability to service its existing debt load. As part of the restructuring, Creditor P exchanged its debt for a new note and shares of mandatorily redeemable preferred stock classified as a liability under ASC 480-10-25-4.

The issuance of liability-classified mandatorily redeemable preferred stock should not be viewed as the granting of an equity interest under ASC 470-60-35-4 or ASC 470-60-35-8. The substance of the exchange of liability-classified mandatorily redeemable equity securities for debt represents a continuation of monetary payments under new terms. Therefore, such a transaction should be accounted for as a modification of the debt terms in accordance with ASC 470-60-35-5 through 35-7. A gain would be recognized only to the extent that the carrying amount of the existing debt exceeds all future payments (including dividends and contingent dividends) to be made on the new note and redeemable equity securities.

By contrast, if G had issued a new note and redeemable preferred stock that qualified for equity classification under ASC 480 (e.g., mandatorily redeemable preferred stock that is convertible into common stock or nonmandatorily redeemable preferred stock), the transaction would be accounted for as a partial settlement in accordance with paragraph ASC 470-60-35-8.

### 11.4.4 Accounting for a Troubled Debt Modification or Exchange

#### 11.4.4.1 Background

If a modification of debt terms qualifies as a TDR, the debtor accounts for the effect of the modification to the debt terms prospectively as an adjustment to the effective interest rate except that the rate cannot be reduced below zero. Although a TDR involves a concession, the debtor does not recognize a restructuring gain (or corresponding adjustment to the net carrying amount) unless the net carrying amount exceeds the total undiscounted future principal and interest payments of the restructured debt.

Accordingly, as of the time of the restructuring, the debtor should compare the total amount of undiscounted future cash payments required by the modified terms (excluding contingently payable amounts) with the debt’s net carrying amount. Different considerations are necessary if the future cash payments exceed the debt’s carrying amount (see Section 11.4.4.2) or if the debt’s carrying amount exceeds the future cash payments (see Section 11.4.4.3). Other special considerations are necessary related to restructured debt with contingent payments (see Section 11.4.4.4); put, call, or prepayment features (see Section 11.4.4.5); and variable-rate debt (see Section 11.4.4.6).
compares the accounting for a troubled debt modification or exchange with that for a nontroubled debt modification or exchange.

Since a TDR involves a concession made by the creditor, a TDR typically cannot result in the recognition of a restructuring loss by the debtor.

### 11.4.4.2 Future Cash Payments Exceed Carrying Amount

<table>
<thead>
<tr>
<th>470-60</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-5 A debtor in a troubled debt restructuring involving only modification of terms of a payable — that is, not involving a transfer of assets or grant of an equity interest — shall account for the effects of the restructuring prospectively from the time of restructuring, and shall not change the carrying amount of the payable at the time of the restructuring unless the carrying amount exceeds the total future cash payments specified by the new terms. Total future cash payments includes related accrued interest, if any, at the time of the restructuring that continues to be payable under the new terms. That is, the effects of changes in the amounts or timing (or both) of future cash payments designated as either interest or face amount shall be reflected in future periods. Interest expense shall be computed in a way such that a constant effective interest rate is applied to the carrying amount of the payable at the beginning of each period between restructuring and maturity (in substance the interest method prescribed by paragraphs 835-30-35-2 and 835-30-35-4 through 35-5). The new effective interest rate shall be the discount rate that equates the present value of the future cash payments specified by the new terms (excluding amounts contingently payable) with the carrying amount of the payable.</td>
</tr>
</tbody>
</table>

If the total amount of future undiscounted cash payments required by the modified terms (excluding contingently payable amounts) exceeds the debt's net carrying amount, a restructuring gain is not recognized and the effective interest rate is adjusted to reflect the modified terms. The adjusted effective interest rate is the discount rate that equates the future cash payments required by the modified agreement, excluding amounts contingently payable, with the debt's net carrying amount at the time of the restructuring. After the TDR, interest expense is recognized by using the adjusted effective interest rate.

### Example 11-15

**Accounting for an Extension of the Maturity Date of a Payable**

Company F has an outstanding note payable that will yield total interest of $4 million. The note matures on September 30, 20X3, on which date the creditor becomes fully entitled to payment of all principal and interest. Company F is experiencing financial difficulties and will be unable to make the scheduled principal and interest payments on the original due date.

On September 1, 20X3, F negotiated an extension of the maturity date to December 31, 20X3. The extension has not changed the amount of principal or interest to be paid by F. The creditor agreed to extend the maturity date to increase its ability to recover its investment. As of September 1, 20X3, $3.5 million had been accrued by F as interest expense.

The extension of the maturity date represents a TDR (see ASC 470-60-15-9(c)(2)). Since the creditor did not obtain any additional entitlement to principal or interest in exchange for the extension, F effectively extended the maturity of its debt at a zero percent interest rate. Company F's remaining unrecognized interest expense ($500,000) on September 1, 20X3, should be accrued by F over the remaining maturity in accordance with ASC 470-60-35-5 (i.e., constant effective interest rate) so that the full amount of interest expense of $4 million will be recognized by December 31, 20X3.
Example 11-16

Accounting for a Reduction in the Interest Rate on a Payable

As of January 1, 20X1, Company B has a note payable to Company S with a principal balance of $95,000, accrued interest of $5,000, an interest rate of 5 percent, and a remaining life of five years. Interest is payable on December 31 each year. Because of B's financial difficulties, S has agreed to forgive all of the accrued interest and lower the stated interest rate to 4 percent.

In this example, the future cash payments exceed the carrying value of the liability (see calculation below). Therefore, in accordance with ASC 470-60-35-5, the net carrying amount of the note is not adjusted.

<table>
<thead>
<tr>
<th>Carrying Amount</th>
<th>Future Cash Flows (Post-Restructuring)</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td>$ 95,000</td>
<td>$ 95,000</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>5,000</td>
<td>19,000</td>
</tr>
<tr>
<td>Total carrying amount</td>
<td>$ 100,000</td>
<td>$ 114,000</td>
</tr>
</tbody>
</table>

The effects of changes in the amount and timing of future cash payments should be accounted for prospectively. A new effective interest rate should be calculated so that the present value of the future payments equals the carrying amount of the liability ($100,000).

Interest Amortization Schedule

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash</th>
<th>Interest at Effective Rate</th>
<th>Reduction in Carrying Value</th>
<th>Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/01/20X1</td>
<td>$ 3,800</td>
<td>$ 2,857</td>
<td>$ 943</td>
<td>$ 99,057</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>3,800</td>
<td>2,830</td>
<td>970</td>
<td>98,087</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>3,800</td>
<td>2,802</td>
<td>998</td>
<td>97,089</td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>3,800</td>
<td>2,774</td>
<td>1,026</td>
<td>96,063</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>3,800</td>
<td>2,737</td>
<td>1,063</td>
<td>95,000</td>
</tr>
</tbody>
</table>

The following entries would be recorded by the debtor to reflect the terms of the modified agreement (note that no entry is required on January 1, 20X1 — the date of the modification):

**Journal Entry: December 31, 20X1**

Interest expense 2,857
Note payable 943
Cash 3,800

To record the interest payment.
Example 11-16 (continued)

Journal Entries: December 31, 20X2–20X5

Per amortization schedule
To record the interest payment.

Journal Entry: December 31, 20X5

<table>
<thead>
<tr>
<th>Note payable</th>
<th>95,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>95,000</td>
</tr>
</tbody>
</table>

To record payment of principal balance.

Example 11-17

Accounting for a Reduction in the Interest Rate on a Payable

On December 31, 20X0, Entity B issues five-year debt for net proceeds of $260,000. The principal amount is $250,000, and the stated interest rate is 5.50 percent payable annually in arrears. Because the debt was issued at net premium, its stated interest rate differs from its effective interest rate. By solving for the rate that equates the initial net proceeds to the future contractual interest and principal cash flows, B determines that the annual effective interest rate is 4.59 percent (see Section 6.2). The full discount amortization schedule is shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Premium Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X0</td>
<td>$ (260,000)</td>
<td></td>
<td></td>
<td>$ 260,000.00</td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>13,750</td>
<td>$ 11,925.24</td>
<td>$ (1,824.76)</td>
<td>258,175.24</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>13,750</td>
<td>11,841.55</td>
<td>(1,908.45)</td>
<td>256,266.79</td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>13,750</td>
<td>11,754.02</td>
<td>(1,995.98)</td>
<td>254,270.81</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>13,750</td>
<td>11,662.47</td>
<td>(2,087.53)</td>
<td>252,183.28</td>
</tr>
<tr>
<td>12/31/20X5</td>
<td>263,750</td>
<td>11,566.72</td>
<td>(2,183.28)</td>
<td>—</td>
</tr>
</tbody>
</table>

Entity B is experiencing financial difficulties and negotiates a debt restructuring with the debt holder. On January 1, 20X3, the holder agrees to reduce the stated coupon rate to 2 percent.

In evaluating whether the holder has granted a concession, B calculates the effective borrowing rate of the restructured debt (see Section 11.3.3.4.1). Entity A solves for the discount rate that equates the future cash flows of the modified debt to the current net carrying amount of the original debt ($256,266.79) and determines that the revised annual effective borrowing rate is 1.15 percent. Because the original effective borrowing rate exceeds the revised effective borrowing rate, the holder has granted a concession. Since B is experiencing financial difficulties, the debt restructuring qualifies as a TDR.

The sum of the undiscounted future contractual interest and principal cash flows ($265,000) exceeds the current net carrying amount of the debt ($256,266.79). Therefore, B does not recognize a restructuring gain; instead, it adjusts the effective interest rate to reflect the modified cash flows.
Example 11-17 (continued)

The revised amortization schedule is shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Premium Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X3</td>
<td>$256,266.79</td>
<td></td>
<td></td>
<td>$256,266.79</td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>$5,000</td>
<td>$2,934.81</td>
<td>$(2,065.19)</td>
<td>254,201.60</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>5,000</td>
<td>2,911.16</td>
<td>(2,088.84)</td>
<td>252,112.76</td>
</tr>
<tr>
<td>12/31/20X5</td>
<td>255,000</td>
<td>2,887.24</td>
<td>(2,112.76)</td>
<td>—</td>
</tr>
</tbody>
</table>

11.4.4.3  Net Carrying Amount Exceeds Future Cash Payments

ASC 470-60

35-6 If, however, the total future cash payments specified by the new terms of a payable, including both payments designated as interest and those designated as face amount, are less than the carrying amount of the payable, the debtor shall reduce the carrying amount to an amount equal to the total future cash payments specified by the new terms and shall recognize a gain on restructuring of payables equal to the amount of the reduction. If the carrying amount of the payable comprises several accounts (for example, face amount, accrued interest, and unamortized premium, discount, finance charges, and issue costs) that are to be continued after the restructuring, some possibly being combined, the reduction in carrying amount may need to be allocated among the remaining accounts in proportion to the previous balances. Thereafter, all cash payments under the terms of the payable shall be accounted for as reductions of the carrying amount of the payable, and no interest expense shall be recognized on the payable for any period between the restructuring and maturity of the payable. The only exception is to recognize interest expense according to paragraph 470-60-35-10. However, the debtor may choose to carry the amount designated as face amount by the new terms in a separate account and adjust another account accordingly.

If the debt's net carrying amount exceeds the total amount of future undiscounted cash payments required by the modified terms (excluding contingently payable amounts), the effective interest rate is reset to zero. Thereafter, the debtor accounts for any cash paid (including amounts designated as interest) as a reduction of the net carrying amount and no interest expense is recognized. As of the time of the restructuring, the debtor should also evaluate whether the modified terms specify any contingently payable or otherwise currently indeterminate amounts (e.g., additional amounts become payable if the debtor's financial situation improves or the stated interest rate is indexed to a market interest rate).

If the modified terms do not specify any contingently payable or otherwise currently indeterminate amounts, the debtor recognizes a debt restructuring gain at the time of the restructuring equal to the excess of the debt's net carrying amount over the total amount of undiscounted future cash payments. However, if the modified terms do specify such amounts, the debtor recognizes a debt restructuring gain only if the debt's net carrying amount exceeds the maximum potential amount of total undiscounted future cash payments that the debtor might be required to pay (irrespective of the likelihood that the debtor would be required to pay them; see Section 11.4.4.4).
Example 11-18

**Calculation of Gain on Modification Involving Forgiveness of Principal and Accrued Interest and a Reduction of the Interest Rate on a Payable**

As of January 1, 20X1, Company B has a note payable to Company S with a principal balance of $100,000, accrued interest of $10,000, an interest rate of 5 percent, and a remaining life of five years. Because of B’s financial difficulties, S agrees to modify the note by reducing the principal amount to $80,000, lowering the stated interest rate to 4 percent, and forgiving all accrued interest. Interest is payable on December 31 each year.

In this example, the future cash payments are less than the carrying value of the liability (see calculation below). Therefore, in accordance with ASC 470-60-35-6, the carrying value of the note should be adjusted. Furthermore, all future cash payments under the terms of the modified agreement should reduce the carrying amount of the note. No interest expense should be recognized on the note payable between the restructuring and the maturity of the note.

The calculation of the debtor’s gain on restructuring is as follows:

<table>
<thead>
<tr>
<th>Carrying Amount</th>
<th>Future Cash Flows (Post-Restructuring)</th>
<th>Debtor’s Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td>$100,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>$10,000</td>
<td>$16,000</td>
</tr>
<tr>
<td>Total carrying amount</td>
<td>$110,000</td>
<td>$96,000</td>
</tr>
</tbody>
</table>

**Journal Entry: December 31, 20X1**

Interest payable 10,000
Note payable 4,000
Gain on debt restructuring 14,000
To record the gain on debt restructuring.

**Journal Entries: December 31, 20X2-20X5**

Note payable 3,200
Cash ($16,000 ÷ 5 years) 3,200
To record “interest” payments. (Note that no interest expense is recorded in this case; cash payments reduce the outstanding principal balance of the note.)

**Journal Entry: December 31, 20X5**

Note payable 80,000
Cash 80,000
To record payment of remaining principal balance.
Example 11-19

Calculation of Gain on Modification Involving a Forgiveness of Principal and a Reduction of the Interest Rate on a Payable

On December 31, 20X0, Entity A issues five-year debt for net proceeds of $120,000. The principal amount is $125,000, and the stated interest rate is 6 percent payable annually in arrears. Because the debt was issued at a net discount, its stated interest rate differs from its effective interest rate. By solving for the rate that equates the initial net proceeds to the future contractual interest and principal cash flows, A determines that the annual effective interest rate is 6.97 percent (see Section 6.2). The full discount amortization schedule is shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Discount Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X0</td>
<td>$120,000.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>$ 7,500</td>
<td>$ 8,369.89</td>
<td>$ 869.89</td>
<td>120,869.89</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>7,500</td>
<td>8,430.56</td>
<td>930.56</td>
<td>121,800.45</td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>7,500</td>
<td>8,495.47</td>
<td>995.47</td>
<td>122,795.92</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>7,500</td>
<td>8,564.90</td>
<td>1,064.90</td>
<td>123,860.82</td>
</tr>
<tr>
<td>12/31/20X5</td>
<td>132,500</td>
<td>8,639.18</td>
<td>1,139.18</td>
<td>—</td>
</tr>
</tbody>
</table>

Entity A is experiencing financial difficulties and negotiates a debt restructuring with the debt holder. On January 1, 20X3, the holder agrees to forgive $15 million of principal and to reduce the stated interest rate to 2 percent. There are no contingently payable or otherwise currently indeterminate amounts payable on the restructured debt.

In evaluating whether the holder has granted a concession, A calculates the effective borrowing rate of the restructured debt (see Section 11.3.3.4.1). Entity A solves for the discount rate that equates the future cash flows of the modified debt to the current net carrying amount of the original debt ($121,800.45) and determines that the revised annual effective borrowing rate is negative. Because the original effective borrowing rate exceeds the revised effective borrowing rate, the holder is deemed to have granted a concession. Since A is experiencing financial difficulties, the debt restructuring qualifies as a TDR.

The sum of the undiscounted future contractual interest and principal cash flows ($116,600) is less than the current net carrying amount of the debt ($121,800.45). Further, there are no contingently payable or otherwise indeterminate amounts. Therefore, A recognizes a restructuring gain for the amount by which the current net carrying amount exceeds the total amount of undiscounted future cash payments; that is, it recognizes a gain of $5,200.45. Further, it adjusts the effective interest rate to zero. The revised amortization schedule is shown below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash Flow</th>
<th>Interest Expense</th>
<th>Premium Amortization</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X3</td>
<td>$116,600</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>$ 2,200</td>
<td>$ —</td>
<td>$ 2,200</td>
<td>114,400</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>2,200</td>
<td>—</td>
<td>2,200</td>
<td>112,200</td>
</tr>
<tr>
<td>12/31/20X5</td>
<td>112,200</td>
<td>—</td>
<td>2,200</td>
<td>—</td>
</tr>
</tbody>
</table>
11.4.4.4 Contingent Payment Terms

11.4.4.4.1 Limit on the Recognition of Restructuring Gains

**ASC 470-60**

35-7 A debtor shall not recognize a gain on a restructured payable involving indeterminate future cash payments as long as the maximum total future cash payments may exceed the carrying amount of the payable. Amounts designated either as interest or as face amount by the new terms may be payable contingent on a specified event or circumstance (for example, the debtor may be required to pay specified amounts if its financial condition improves to a specified degree within a specified period). To determine whether the debtor shall recognize a gain according to the provisions of the preceding two paragraphs, those contingent amounts shall be included in the total future cash payments specified by the new terms to the extent necessary to prevent recognizing a gain at the time of restructuring that may be offset by future interest expense. Thus, the debtor shall apply paragraphs 450-30-25-1 and 450-30-50-1 in which probability of occurrence of a gain contingency is not a factor, and shall assume that contingent future payments will have to be paid. The same principle applies to amounts of future cash payments that must sometimes be estimated to apply the provisions of the preceding two paragraphs. For example, if the number of future interest payments is flexible because the face amount and accrued interest is payable on demand or becomes payable on demand, estimates of total future cash payments shall be based on the maximum number of periods possible under the restructured terms.

Sometimes, the terms of restructured debt specify contingently payable amounts. For example, the debtor might be required to pay additional amounts of principal or interest if its financial condition or financial performance improves. To prevent offsetting by future interest expense, ASC 470-60 precludes the recognition of a restructuring gain if the restructured debt specifies contingent payments and the maximum total possible amount of contingent and noncontingent payments equals or exceeds the net carrying amount of the debt. The likelihood that contingent payments might need to be paid is not a factor. In determining the amount of any restructuring gain, the debtor must assume that it will have to pay the maximum amount possible under any contingent payment terms. Therefore, the debtor should reduce the amount of any restructuring gain that would otherwise have been recognized up to the maximum total undiscounted amount of any contingent payments.

As noted above, the purpose of the guidance is to prevent the debtor from recognizing a restructuring gain that might be offset by future losses under contingent payment terms. This means that the debtor should first compare (1) the debt's net carrying amount immediately before the modification with (2) the total amount of undiscounted future cash payments required by the modified debt terms (excluding contingently payable amounts):

- If the total amount of undiscounted future cash payments (excluding contingently payable amounts) exceeds the net carrying amount immediately before the debt restructuring, the debtor adjusts the effective interest rate prospectively to reflect the modified cash flows (see Section 11.4.4.2). In this circumstance, there is no restructuring gain, the net carrying amount is not adjusted, and no portion of the net carrying amount is attributable to contingently payable amounts at the time of the restructuring.
- If the net carrying amount immediately before the debt restructuring exceeds the amount of undiscounted future cash payments (excluding contingently payable amounts), the effective interest rate is reset to zero (see Section 11.4.4.3). Further, in this circumstance, the debtor should compare the net carrying amount immediately before the modification with the total
amount of undiscounted future cash payments required by the modified terms (including contingently payable amounts):

- If the net carrying amount immediately before the debt restructuring exceeds the total amount of undiscounted future cash payments required by the modified terms (including contingently payable amounts), the debtor recognizes a debt restructuring gain and a corresponding decrease in the net carrying amount for the difference at the time of the restructuring. In this circumstance, any or all contingently payable amounts are included in the net carrying amount as if they were not contingent.

- If the total amount of undiscounted future cash payments required by the modified terms (including contingently payable amounts) exceeds the net carrying amount immediately before the debt restructuring, there is no restructuring gain and the net carrying amount is not adjusted. In this circumstance, a portion of contingently payable amounts are included in the net carrying amount at the time of the restructuring but only to the extent that they offset the contingent gain that would otherwise have been recognized.

Note that contingently payable amounts include cash as well as other contingently payable amounts (e.g., equity shares).

**Example 11-20**

**Accounting for a Modification Involving Contingently Payable Amounts**

Entity A has outstanding debt with a net carrying amount of $1.5 million, an effective interest rate of 10 percent per annum, and a remaining term of eight years. On January 1, 20X1, A is experiencing financial difficulties and negotiates a debt restructuring with its creditor. Under the terms of the restructured debt, the creditor reduces the principal amount to $750,000 (i.e., it forgives $750,000). The stated rate of the restructured debt is 10 percent per annum payable annually in arrears. The maturity date is not modified. In conjunction with the modification, A agrees that if it is acquired by a third party at any time before the final maturity of the debt, it will make an additional payment to the creditor in an amount equal to the forgiven principal amount.

On the basis of the net carrying amount and the modified cash flows, excluding the contingent payment that will be made if A is acquired, A determines that the undiscounted future cash flows (i.e., $1,350,000, or $750,000 + [($750,000 × .10 × 8)]) are less than the existing carrying amount of the debt (i.e., $1,500,000). Because A is experiencing financial difficulties and a concession has been granted, TDR accounting applies. The maximum total possible amount of principal and interest payments is $2.1 million. Consequently, there should be no change to the net carrying amount of the debt and no interest expense recognized prospectively provided that an acquisition of A is not expected. Any remaining carrying amount of the debt at maturity would be recognized by A as a gain as long as an acquisition of A did not occur.

**11.4.4.4.2 Subsequent Accounting**

**ASC 470-60**

35-10 If a troubled debt restructuring involves amounts contingently payable, those contingent amounts shall be recognized as a payable and as interest expense in future periods in accordance with paragraph 450-20-25-2. Thus, in general, interest expense for contingent payments shall be recognized in each period in which both of the following conditions exist:

a. It is probable that a liability has been incurred.

b. The amount of that liability can be reasonably estimated.

Before recognizing a payable and interest expense for amounts contingently payable, however, accrual or payment of those amounts shall be deducted from the carrying amount of the restructured payable to the extent that contingent payments included in total future cash payments specified by the new terms prevented recognition of a gain at the time of restructuring (see paragraph 470-60-35-7).
The accounting for probable and actual losses under contingent payment terms after the debt restructuring depends on whether those losses were included in the net carrying amount at the time of the restructuring. To the extent that potential losses under contingent payment terms prevented the recognition of a restructuring gain at the time of the restructuring (i.e., they are included in the debt’s net carrying amount), the realization of such losses after the debt restructuring are accounted for as a direct reduction of the debt’s net carrying amount (e.g., as debit to debt and a credit to cash). When the debt’s net carrying amount includes an accrual for such losses at the time of the restructuring, it would be inappropriate to recognize an additional payable for the losses without a corresponding reduction in the net carrying amount (i.e., the same losses would be counted twice).

Unless the contingent payment feature is bifurcated as a derivative instrument under ASC 815-15, the debtor should apply a loss contingency approach in a manner similar to that in ASC 450-20 to accrue for any estimated losses under contingent payment terms that exceed the amount of contingently payable amounts that were included in the net carrying amount at the time of the restructuring. That is, the debtor would recognize interest expense with a corresponding increase to the net carrying amount of the debt (or a separate payable) if such incremental losses are probable and can be reasonably estimated.

A debtor is required to disclose the extent to which inclusion of contingent future cash payments prevented the recognition of a restructuring gain under ASC 470-60-35-7 (see Section 11.5.2).

**Connecting the Dots**

Note that although interest payments that vary on the basis of a variable interest rate are similar to contingent payments in that their amount is uncertain at the time of the restructuring, they are accounted for differently from contingent payments (see Section 11.4.4.6).

### 11.4.4.5 Put, Call, or Prepayment Features

Sometimes, restructured debt includes put, call, or prepayment features. For example, the debt might be repayable on demand so that the total amount of undiscounted future cash payments that the debtor might have to pay depends on whether and, if so, when the creditor demands repayment of the debt. In determining whether to recognize a restructuring gain, the debtor analyzes a call, put, or prepayment feature that could accelerate the repayment of the restructured debt in a manner similar to how it analyzes a contingent payment term. That is, the debtor assumes that it will be required to make the maximum potential amount of principal and interest payments (i.e., the debt will be outstanding for the maximum number of periods possible).

A debtor should disregard the possibility that the net carrying amount of the debt could exceed the total amount of principal and interest payments that the debtor may pay over the life of the debt in determining whether to bifurcate the put, call, or prepayment feature as a derivative instrument under ASC 815-15. Because ASC 470-60 requires the debtor to assume that it will need to pay the maximum amount possible to prevent the recognition of a gain that may not be realized, it is reasonable for the debtor to assume that the debt cannot be prepaid at an amount less than the net carrying amount. However, to the extent that the debt could be prepaid at an amount in excess of the net carrying amount, it would be appropriate to analyze the put, call, or prepayment feature as an embedded feature that may need to be bifurcated under ASC 815-15.
11.4.4.6 Variable-Rate Debt

ASC 470-60

If amounts of future cash payments must be estimated to apply the provisions of paragraphs 470-60-35-5 through 35-7 because future interest payments are expected to fluctuate — for example, the restructured terms may specify the stated interest rate to be the prime interest rate increased by a specified amount or proportion — estimates of maximum total future payments shall be based on the interest rate in effect at the time of the restructuring. Fluctuations in the effective interest rate after the restructuring from changes in the prime rate or other causes shall be accounted for as changes in estimates in the periods in which the changes occur. However, the accounting for those fluctuations shall not result in recognizing a gain on restructuring that may be offset by future cash payments (see the preceding paragraph and paragraph 470-60-35-7). Rather, the carrying amount of the restructured payable shall remain unchanged, and future cash payments shall reduce the carrying amount until the time that any gain recognized cannot be offset by future cash payments.

If interest payments on restructured debt are variable (e.g., indexed to the prime rate or LIBOR), the debtor must estimate the total amount of undiscounted future variable interest payments. To estimate that amount, the debtor uses the current variable interest rate in effect at the time of the restructuring (or the “TDR rate”). For example, if the restructured debt's interest payments are indexed to the prime rate, the debtor estimates future interest payments on the basis of the assumption that the prime rate will not change in future periods.

The debtor determines whether it should recognize a restructuring gain at the time of the restructuring as follows:

- If the net carrying amount exceeds the total amount of estimated future undiscounted cash payments (including variable cash payments estimated at the TDR rate and the maximum possible amount of other contingently payable amounts), the debtor recognizes a restructuring gain and a corresponding adjustment to the net carrying amount at the time of the restructuring. Unlike the accounting for other contingently payable amounts discussed in Section 11.4.4.4.1, a restructuring gain may be recognized at the time of the debt restructuring even if it is possible that it will be offset by future interest expense should actual payments exceed estimated payments because of an increase in variable interest rates.

- If the total amount of estimated future undiscounted cash payments (including variable cash payments estimated at the TDR rate and the maximum possible amount of other contingently payable amounts) exceeds the debt's net carrying amount at the time of the restructuring, the debtor does not recognize a restructuring gain.
After the TDR, the debtor would recognize interest expense on variable-rate debt in three circumstances:

- If the variable rate exceeds the TDR rate (i.e., interest rates have increased), the debtor accrues interest expense for such excess since those amounts were not included in the net carrying amount at the time of the restructuring. The amount of additional interest expense equals the product of the net carrying amount and the difference between the current rate and the TDR rate. When the variable rate exceeds the TDR rate in a specific financial reporting period, an entity may calculate the amount of interest expense to accrue in that period either on a period-by-period basis or a cumulative basis. Under a period-by-period approach, additional interest is accrued in each period in which the variable rate exceeds the TDR rate irrespective of whether the TDR rate exceeded the variable rate in a prior period. Under a cumulative approach, additional interest is accrued if the cumulative amount of interest accrued at the actual variable rates in effect for each period since the TDR exceeds the cumulative amount of interest accrued at the TDR rate in each period since the TDR.

- If the total amount of estimated future undiscounted cash payments (including variable interest payments estimated at the TDR rate but excluding contingently payable amounts) exceeds the debt’s net carrying amount at the time of the restructuring (i.e., there was no restructuring gain; see Section 11.4.4.2), the debtor should accrue interest expense over the life of the restructured debt for the difference between the net carrying amount and the total amount of undiscounted future principal and estimated interest payments estimated at the TDR rate, since such amounts were not included in the debt’s net carrying amount at the time of the restructuring.

- The debtor should expense any estimated losses under contingent payment terms that exceed the amount included in the net carrying amount at the time of the restructuring (see Section 11.4.4.4.2).

Other than in the above three circumstances, the debtor would recognize no interest expense on variable-rate debt after the TDR since amounts payable as interest directly reduce the debt’s net carrying amount.

In situations in which the TDR rate exceeds the variable rate in a subsequent period (i.e., interest rates have decreased), ASC 470-60 precludes the debtor from recognizing a gain for the difference between actual and estimated payments before the debt’s extinguishment (see Section 9.2) since such a gain might be offset by future cash payments if the variable rate increases again before the debt is settled. The debtor recognizes the gain only when no obligations remain (i.e., when the debt is extinguished).
Example 11-21

**Accounting for a Modification of a Payable — Interest Rate Changed From Fixed Rate to Variable Rate**

Debtor D has a fixed-rate loan with a net carrying amount of $100,000 and a remaining term of five years. The stated interest rate is 12 percent per annum payable in arrears. The loan was originated at no discount or premium, and the debt issuance costs were negligible. Because of D’s financial difficulties, on January 1, 20X1, its lender agrees to forgive $25,000 of principal and change the interest rate to the prime rate plus 1 percent per annum (i.e., the interest rate on the restructured debt is variable). At the time of the restructuring, the prime rate is 4.5 percent.

Debtor D estimates the future principal and interest cash flows on the restructured debt on the basis of the prime rate in effect at the time of the restructuring (i.e., the TDR rate). On the basis of the net carrying amount ($100,000) and the future cash flows of the restructured debt estimated at the TDR rate (5.50 percent), which is $95,625, D determines that the effective borrowing rate on the restructured debt is negative (see Section 11.3.3.4.1). Because the principal amount of the original debt was equal to its net carrying amount, the effective borrowing rate on the original debt was equal to its stated interest rate of 12 percent per annum.

Since the effective borrowing rate of the modified loan is lower than that of the original debt, the lender has granted a concession. Because D is experiencing financial difficulties, TDR accounting applies.

The net carrying amount ($100,000) exceeds the total amount of undiscounted principal and interest cash flows estimated at the TDR rate ($95,625). Therefore, D recognizes a restructuring gain ($4,375) at the time of the restructuring with a corresponding reduction in the debt’s net carrying amount. Subsequent variable interest payments are recognized as a reduction in the debt’s net carrying amount except to the extent that variable interest payments exceed the amount estimated at the TDR rate. Because the total amount that D estimated it would pay as interest at the TDR rate exceeds its actual interest payments over the debt’s life, it also recognizes a gain for the difference when the debt matures.

<table>
<thead>
<tr>
<th>Date</th>
<th>Estimated Cash Flows at TDR Rate (5.50%)</th>
<th>Prime Rate</th>
<th>Actual Cash Flows</th>
<th>Interest Expense</th>
<th>Gain</th>
<th>Net Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/20X0</td>
<td>$100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td>1/1/20X1</td>
<td>$4,125</td>
<td>$4.50</td>
<td>$4,125</td>
<td>$4,125</td>
<td>$4,375</td>
<td>$95,625</td>
</tr>
<tr>
<td>12/31/20X1</td>
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<td>$6.00</td>
<td>$5,250</td>
<td>$1,125</td>
<td></td>
<td>$91,500</td>
</tr>
<tr>
<td>12/31/20X2</td>
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<td></td>
<td>$83,250</td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>$4,125</td>
<td>$4.00</td>
<td>$3,750</td>
<td>$375</td>
<td></td>
<td>$79,500</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>$79,125</td>
<td>$3.50</td>
<td>$78,375</td>
<td></td>
<td>$1,125</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$95,625</td>
<td>$96,000</td>
<td>$1,500</td>
<td></td>
<td>$5,500</td>
<td></td>
</tr>
</tbody>
</table>
### 11.4.4.7 Comparison of ASC 470-50 and ASC 470-60

A debt modification or exchange that qualifies as a TDR should be accounted for as a modification of the debt terms under ASC 470-60 irrespective of whether the original and new terms are substantially different. This is unlike the analysis of a debt modification or exchange that does not qualify as a TDR under ASC 470-50, which should be accounted for as a debt modification or an extinguishment depending on whether the terms are substantially different (see Chapter 10). The following table depicts key differences between the accounting for a debt modification or exchange depending on whether the transaction qualifies as a TDR:

<table>
<thead>
<tr>
<th>TDR (ASC 470-60)</th>
<th>Not a TDR (ASC 470-50)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Future Undiscounted Cash Flows Exceed Original Net Carrying Amount</strong></td>
<td><strong>Original Net Carrying Amount Exceeds Future Undiscounted Cash Flows</strong></td>
</tr>
<tr>
<td>Terms substantially different</td>
<td>• The net carrying amount is reduced for restructuring fees paid to the creditor.</td>
</tr>
<tr>
<td></td>
<td>• No restructuring gain is recognized.</td>
</tr>
<tr>
<td></td>
<td>• Third-party restructuring costs are expensed.</td>
</tr>
<tr>
<td></td>
<td>• The effective interest rate is adjusted prospectively on the basis of the adjusted net carrying amount and the revised cash flows.</td>
</tr>
<tr>
<td></td>
<td>• The carrying amount is reduced to the amount of future undiscounted cash flows.</td>
</tr>
<tr>
<td></td>
<td>• The difference between the undiscounted amount of future cash flows and the net carrying amount is recognized as a restructuring gain.</td>
</tr>
<tr>
<td></td>
<td>• Third-party restructuring costs reduce any gain.</td>
</tr>
<tr>
<td></td>
<td>• No interest expense is recognized prospectively. Instead, subsequent interest payments reduce the debt's carrying amount.</td>
</tr>
<tr>
<td>Terms not substantially different</td>
<td>• The net carrying amount is reduced for restructuring fees paid to the creditor.</td>
</tr>
<tr>
<td></td>
<td>• No restructuring gain is recognized.</td>
</tr>
<tr>
<td></td>
<td>• Third-party restructuring costs are expensed.</td>
</tr>
<tr>
<td></td>
<td>• The effective interest rate is adjusted prospectively on the basis of the adjusted net carrying amount and the revised cash flows.</td>
</tr>
<tr>
<td></td>
<td>• The carrying amount is reduced to the amount of future undiscounted cash flows.</td>
</tr>
<tr>
<td></td>
<td>• The difference between the undiscounted amount of future cash flows and the net carrying amount is recognized as a restructuring gain.</td>
</tr>
<tr>
<td></td>
<td>• Third-party restructuring costs reduce any gain.</td>
</tr>
<tr>
<td></td>
<td>• No interest expense is recognized prospectively. Instead, subsequent interest payments reduce the debt's carrying amount.</td>
</tr>
</tbody>
</table>
The example below discusses a debt modification that qualifies as a TDR. Note that some of the details in the example are the same as those in the illustration of a creditor’s analysis in paragraphs 117 and 118 of the Basis for Conclusions of FASB Statement 15. The debtor’s analysis of the same set of facts is also compared with ASC 470-50 for a debt modification that does not qualify as a TDR.

**Example 11-22**

**Debtor’s Analysis of a Debt Modification That Qualifies as a TDR**

Entity D issues debt on which it must make interest payments of $100 at the end of each year for five more years and repay the $1,000 face amount at the end of those five years. The stated interest rate is 10 percent, compounded annually. The debt’s initial and current net carrying amount is $1,000, and the annual effective interest rate implicit in the debt is also 10 percent. If all contractual amounts are paid, the debtor’s total interest expense will be $500 — the difference between the total amount to be paid ($1,500) and the debt’s net carrying amount ($1,000). The effective interest rate on the $1,000 net carrying amount will be 10 percent.

Entity D and the creditor are considering whether to modify the debt in one of the following four ways:

1. **Timing of interest only** — Terms modified to defer payment of interest until the debt matures (a single collection of $500 at the end of five years is substituted for five annual collections at $100).
2. **Amount of interest only** — Terms modified to leave unchanged the timing of interest and the timing and amount of principal payment but to reduce the annual interest from $100 to $60.
3. **Amount of principal only** — Terms modified to leave unchanged the amounts and timing of interest but to reduce the principal amount to $800 due at the end of five years.
4. **Both timing of interest and principal amount** — Terms modified to defer collection of interest until the debt matures and to reduce the principal amount to $800 (modifications 1 and 3 combined).

The contractual cash payments before the modification and in the above four modification scenarios are as follows:

<table>
<thead>
<tr>
<th>Contractual Cash Flows</th>
<th>Before Modification</th>
<th>Modification Scenario 1</th>
<th>Modification Scenario 2</th>
<th>Modification Scenario 3</th>
<th>Modification Scenario 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$ 100</td>
<td>$ —</td>
<td>$ 60</td>
<td>$ 100</td>
<td>$ —</td>
</tr>
<tr>
<td>Year 2</td>
<td>100</td>
<td>—</td>
<td>60</td>
<td>100</td>
<td>—</td>
</tr>
<tr>
<td>Year 3</td>
<td>100</td>
<td>—</td>
<td>60</td>
<td>100</td>
<td>—</td>
</tr>
<tr>
<td>Year 4</td>
<td>100</td>
<td>—</td>
<td>60</td>
<td>100</td>
<td>—</td>
</tr>
<tr>
<td>Year 5</td>
<td>1,100</td>
<td>1,500</td>
<td>1,060</td>
<td>900</td>
<td>1,300</td>
</tr>
<tr>
<td>Total undiscounted</td>
<td>$ 1,500</td>
<td>$ 1,500</td>
<td>$ 1,300</td>
<td>$ 1,300</td>
<td>$ 1,300</td>
</tr>
</tbody>
</table>

If D and the creditor modified the debt terms in accordance with one of the above four scenarios and the modification qualifies as a TDR under ASC 470-60, D would reduce the effective interest rate used to calculate interest expense on the debt prospectively in each of the four modification scenarios above in accordance with ASC 470-60-35-5 (see **Section 11.4.4.2**). The revised effective interest rate would be the discount rate that equates the future cash payments specified by the new terms with the debt’s net carrying amount (see row (d) in the table below). Because the modified remaining cash payments would exceed the net carrying amount, the carrying amount would not be adjusted, and there would be no restructuring gain in any scenario in accordance with ASC 470-60.
### Example 11-22 (continued)

The following table illustrates the analysis under ASC 470-60 of each of these scenarios:

<table>
<thead>
<tr>
<th>ASC 470-60 Analysis</th>
<th>Before Modification</th>
<th>Modification Scenario 1 (Timing Only)</th>
<th>Modification Scenario 2 (Amount of Interest Only)</th>
<th>Modification Scenario 3 (Amount of Principal Only)</th>
<th>Modification Scenario 4 (Timing and Amount)</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Amount by which total remaining cash payments specified by the terms exceed the debt's net carrying amount:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>$ 500</td>
<td>$ 500</td>
<td>$ 300</td>
<td>$ 500</td>
<td>$ 500</td>
</tr>
<tr>
<td>Principal amount</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>800</td>
<td>800</td>
</tr>
<tr>
<td>Total cash payments</td>
<td>1,500</td>
<td>1,500</td>
<td>1,300</td>
<td>1,300</td>
<td>1,300</td>
</tr>
<tr>
<td>Net carrying amount</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Excess of specified cash payments over net carrying amount ($1,000)</td>
<td>$ 500</td>
<td>$ 500</td>
<td>$ 300</td>
<td>$ 300</td>
<td>$ 300</td>
</tr>
<tr>
<td>b. Restructuring gain?</td>
<td>N/A</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c. Net carrying amount after modification</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>d. Revised effective interest rate on the net carrying amount</td>
<td>10.0%</td>
<td>8.5%</td>
<td>6.0%</td>
<td>6.5%</td>
<td>5.4%</td>
</tr>
<tr>
<td>e. Interest expense for the year following the TDR</td>
<td>$ 100</td>
<td>$ 85</td>
<td>$ 60</td>
<td>$ 65</td>
<td>$ 54</td>
</tr>
</tbody>
</table>

If the debt modification was not a TDR, the accounting analysis for the same set of facts would be different. Because the present value of the modified cash payments discounted at the original effective interest rate would be more than 10 percent different from the net carrying amount (i.e., the present value of the original cash payments discounted at the original effective interest rate) in scenarios 2, 3, and 4, the original debt would be accounted for as an extinguishment under ASC 470-50 (see Section 10.4.2). Therefore, the new debt would be recognized at its fair value as of the modification date, an extinguishment gain or loss would be recognized for the difference between the net carrying amount and the current fair value, and a new effective interest rate would be calculated on the basis of the initial net carrying amount of the modified debt.
Example 11-22 (continued)

In scenario 1, the present value of the modified cash payments discounted at the original effective interest rate is less than 10 percent different from the net carrying amount. Therefore, the debt would not qualify for extinguishment accounting under ASC 470-50 (see Section 10.4.3). Instead, D would calculate a revised effective interest rate in accordance with ASC 470-50-40-14 (see row (l) below). The table below illustrates the analysis under ASC 470-50 of each of the above modification scenarios in situations in which the modification does not qualify as a TDR. It is assumed in the scenarios that the applicable current market interest rate for the debt is 5.5 percent.

<table>
<thead>
<tr>
<th>ASC 470-50 Analysis</th>
<th>Before Modification</th>
<th>Modification Scenario 1</th>
<th>Modification Scenario 2</th>
<th>Modification Scenario 3</th>
<th>Modification Scenario 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>f. Present value of the original cash payments discounted at the original effective interest rate</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>g. Present value of the modified cash payments discounted at the original effective interest rate</td>
<td>$1,000</td>
<td>$931</td>
<td>$848</td>
<td>$876</td>
<td>$807</td>
</tr>
<tr>
<td>h. Percentage difference in present value</td>
<td>N/A</td>
<td>6.9%</td>
<td>15.2%</td>
<td>12.4%</td>
<td>19.3%</td>
</tr>
<tr>
<td>i. Extinguishment accounting?</td>
<td>N/A</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>j. Fair value of the debt at an assumed current market interest rate of 5.5%</td>
<td>$1,192</td>
<td>$1,148</td>
<td>$1,021</td>
<td>$1,039</td>
<td>$995</td>
</tr>
<tr>
<td>k. Extinguishment gain (loss)</td>
<td>N/A</td>
<td>N/A</td>
<td>($21)</td>
<td>($39)</td>
<td>$5</td>
</tr>
<tr>
<td>l. Net carrying amount after modification</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,021</td>
<td>$1,039</td>
<td>$995</td>
</tr>
<tr>
<td>m. Effective interest rate after modification</td>
<td>N/A</td>
<td>8.5%</td>
<td>5.5%</td>
<td>5.5%</td>
<td>5.5%</td>
</tr>
<tr>
<td>n. Interest expense for the year following the modification</td>
<td>$100</td>
<td>$85</td>
<td>$56</td>
<td>$57</td>
<td>$55</td>
</tr>
</tbody>
</table>
11.4.5 Accounting for a Combination of TDR Characteristics

<table>
<thead>
<tr>
<th>ASC 470-60</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-8 A troubled debt restructuring may involve partial settlement of a payable by the debtor's transferring assets or granting an equity interest (or both) to the creditor and modification of terms of the remaining payable. Even if the stated terms of the remaining payable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the transfer of assets or grant of an equity interest, the restructuring shall be accounted for as prescribed by this guidance. A debtor shall account for a troubled debt restructuring involving a partial settlement and a modification of terms as prescribed in paragraphs 470-60-35-5 through 35-7 except that, first, assets transferred or an equity interest granted in that partial settlement shall be measured as prescribed in paragraphs 470-60-35-2 and 470-60-35-4, respectively, and the carrying amount of the payable shall be reduced by the total fair value of those assets or equity interest. If cash is paid in a partial settlement of a payable in a troubled debt restructuring, the carrying amount of the payable shall be reduced by the amount of cash paid. A difference between the fair value and the carrying amount of assets transferred to the creditor shall be recognized as a gain or loss on transfer of assets. No gain on restructuring of payables shall be recognized unless the remaining carrying amount of the payable exceeds the total future cash payments (including amounts contingently payable) specified by the terms of the debt remaining unsettled after the restructuring. Future interest expense, if any, shall be determined according to the provisions of paragraphs 470-60-35-5 through 35-7.</td>
</tr>
</tbody>
</table>

Some TDRs involve a partial settlement of the debt through a transfer of cash or other assets or the issuance of equity instruments. The terms of the remaining debt might also be modified. When a TDR involves a combination of the characteristics in ASC 470-60-15-9(a)–(c), the accounting is as follows:

- The debt's net carrying amount is reduced by the amount of any cash paid to the creditor.
- The debtor recognizes a gain or loss on any noncash assets transferred that is equal to the difference between their carrying amount and fair value and reduces the debt's net carrying amount by that fair value.
- The debtor recognizes the issuance of any equity instruments at fair value and reduces the net carrying amount of the debt by that fair value.
- Once the net carrying amount has been reduced for the amount of cash and the fair value of any assets transferred or equity interests granted, the debtor applies the accounting requirements for troubled debt modifications and exchanges (see Section 11.4.4) to the remaining debt on the basis of the reduced net carrying amount.

The guidance in ASC 470-60-35-8 applies to a TDR with a combination of the characteristics specified in ASC 470-60-15-9(a)–(c) even if such TDR does not involve a partial settlement of the debt (e.g., an asset transfer and debt modification that does not involve a reduction of the debt's principal amount). Also, note that the fair value of the assets transferred or equity instruments issued may be different from any reduction in the debt's net carrying amount agreed to by the debtor and creditor.
Example 11-23

**Accounting for a Modification Involving a Reduction of Interest Rate on a Payable in Exchange for an Issuance of Common Stock**

A company issues common stock to fixed-rate debt holders in exchange for delaying interest payments on the outstanding debt. The transaction qualifies as a TDR. Although none of the debt has been settled as a result of this transaction, this arrangement is analogous to a TDR with a combination of the characteristics described in ASC 470-60-15-6(a)–(c). ASC 310-40-15-6(a) indicates that:

A creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor.

The company should reduce the carrying amount of the debt by the fair value of the common stock issued, and it would not record a gain because the adjusted carrying amount of the debt does not exceed the total future cash payments required by the new terms (only the timing of the payments was affected). The reduction of the carrying amount effectively creates a discount on the debt, which will result in increased interest expense prospectively over the remaining term of the debt, as described in ASC 470-60-35-5 through 35-7.

11.5  Presentation and Disclosure

11.5.1  Current Versus Noncurrent Classification

<table>
<thead>
<tr>
<th>ASC 470-60</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-1</strong></td>
</tr>
<tr>
<td><strong>45-2</strong></td>
</tr>
</tbody>
</table>

Like a credit-related covenant violation that takes place after the balance sheet date, a TDR that occurs after the balance sheet date may affect the classification of the related debt as current or noncurrent as of such date (see Section 13.5).
11.5.2 Disclosure

<table>
<thead>
<tr>
<th>ASC 470-60</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-1</strong> A debtor shall disclose, either in the body of the financial statements or in the accompanying notes, all of the following information about troubled debt restructurings that have occurred during a period for which financial statements are presented:</td>
</tr>
<tr>
<td>a. For each restructuring, a description of the principal changes in terms, the major features of settlement, or both; separate restructurings within a fiscal period for the same category of payables (for example, accounts payable or subordinated debentures) may be grouped for disclosure purposes</td>
</tr>
<tr>
<td>b. Aggregate gain on restructuring of payables</td>
</tr>
<tr>
<td>c. Aggregate net gain or loss on transfers of assets recognized during the period (see paragraphs 470-60-35-3 and 470-60-35-8)</td>
</tr>
<tr>
<td>d. Per-share amount of the aggregate gain on restructuring of payables.</td>
</tr>
</tbody>
</table>

**50-2** A debtor shall disclose in financial statements for periods after a troubled debt restructuring the extent to which amounts contingently payable are included in the carrying amount of restructured payables pursuant to the provisions of paragraph 470-60-35-7. If required by paragraphs 450-20-50-1 through 50-6 and 450-20-50-9 through 50-10, a debtor shall also disclose in those financial statements total amounts that are contingently payable on restructured payables and the conditions under which those amounts would become payable or would be forgiven.

ASC 470-60-50-1 and 50-2 specify the disclosure requirements for a TDR that has occurred during a financial reporting period. Such disclosures are required even if the debt is no longer outstanding.
Chapter 12 — Debt Conversions

12.1 Background
This chapter describes the accounting for a conversion of debt into the debtor's equity shares in situations in which the conversion does not have to be treated as a debt extinguishment (see Chapter 9), as a debt modification or exchange (see Chapter 10), or as a TDR (see Chapter 11).

12.2 Scope
ASC 470-20 discusses the accounting for a conversion of debt into the debtor's equity shares in accordance with the debt's original conversion terms (see Section 12.3.2) or under an induced conversion (see Section 12.3.4). However, debt conversions and exchanges of debt into the debtor's equity shares must be accounted for as debt extinguishments (see Section 9.3) in the following scenarios:

• 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 12.3.3).
• A conversion that occurs in accordance with changed conversion privileges that does not meet the criteria for induced conversion accounting (see Section 12.3.4).
• A conversion of debt into a variable number of shares in accordance with a share-settled redemption or indexation feature (e.g., the number of shares delivered is determined to have a fair value equal to the redemption amount; see Section 8.4.7.2.5).
• The repayment of convertible debt by the delivery of the debtor's equity shares if the debtor is using its own shares as a means of currency to settle the debt obligation's value (e.g., the number of shares delivered is determined to have a value equal to the monetary amount of the debt obligation).

Further, it may be appropriate to apply extinguishment accounting to conversions of convertible debt for which the conversion feature was separated as a derivative instrument under ASC 815-15 (see Section 12.4).

If a debtor is experiencing financial difficulties and the creditor grants a concession (see Section 11.3), the debtor should evaluate whether the settlement of debt by the issuance of equity shares must be accounted for as a TDR (see Section 11.4.2 and 11.4.5). A debtor that exchanges debt for shares that must be classified as liabilities under ASC 480-10 (e.g., share-settled debt; see Section 2.3.2.3) should evaluate whether it is required to account for the exchange as a modification or an extinguishment of the original debt (see Section 10.2.12).

In certain circumstances, the tendering of debt upon the exercise of a detachable warrant is accounted for as a debt conversion and not as a debt extinguishment (see Section 9.3.6).
12.3 Convertible Debt With No BCF or Equity Component

12.3.1 Background

If convertible debt does not contain a bifurcated embedded conversion feature under ASC 815-15 or a separately recognized equity component, the debtor’s accounting for the conversion (or exchange) of the debt into the debtor’s equity-classified 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 debt is converted into the issuer’s equity shares under the instrument’s original conversion terms (other than a share-settled redemption or indexation feature, see Section 8.4.7.2.5) 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 12.3.2).

- **Conversion upon the issuer’s exercise of a call option** — If debt is converted into the issuer’s equity shares under the instrument’s original conversion terms (other than a share-settled redemption or indexation 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 settlement of the instrument is accounted for as a conversion in accordance with the instrument’s original terms. If the conversion option was nonsubstantive at issuance, the settlement of the instrument is accounted for as a debt extinguishment (see Section 9.3).

- **Induced conversions** — If the conversion of debt into the issuer’s equity shares qualifies as an “induced conversion” under 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 12.3.4).

- **Conversion in a TDR** — If debt is exchanged into the issuer’s equity shares under a TDR as defined in ASC 470-60 (see Section 11.3) 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 11.4). If the holder is a related party, the issuer should consider whether the transaction represents a capital transaction (see Section 11.4.1.5).

- **Other conversions and exchanges** — If debt is converted (or exchanged) into the issuer’s equity shares in accordance with a share-settled redemption feature or on terms that are different 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 settlement is accounted for as a debt extinguishment (see Section 9.3). 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. If the holder is a related party, the issuer should consider whether the transaction represents a capital transaction (see Section 9.3.7.2).

If a debtor exchanges debt for shares that must be classified as liabilities under ASC 480-10, such as share-settled debt (see Section 2.3.2.3), it should evaluate whether it is required to account for the exchange as a modification or an extinguishment of the original debt (see Section 10.2.12).
12.3.2 Conversion in Accordance With the Original Conversion Terms

ASC 470-20-40-4 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.

ASC 470-20 specifies the accounting for a conversion of a convertible debt instrument that does not contain a bifurcated embedded conversion feature under ASC 815-15 and is not addressed by other guidance (see below). Under this guidance, which is sometimes referred to as “conversion accounting” (as opposed to “extinguishment accounting”), the net carrying amount of the debt is credited to equity upon conversion to reflect the equity shares issued, and no gain or loss is recognized. For example, 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 (see Section 9.3.1.3). 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 12.8).

This guidance does not apply to any of the following transactions:

- 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 12.3.3).
- Induced conversions as described in ASC 470-20-40-13 (see Section 12.3.4).
- A conversion of a convertible debt instrument with a separately recognized equity component that is not a BCF or CCF (see Section 12.5).
- A conversion of a convertible debt instrument that is within the scope of the CCF guidance in ASC 470-20 (see Section 12.6).
- A conversion of a convertible debt instrument that contained a recognized BCF (see Section 12.7).
- A conversion that represents a TDR as defined in ASC 470-60 (see Chapter 11).
- A conversion that occurs in accordance with the terms of a share-settled redemption feature (see Section 8.4.7.2.5).
- An exchange of debt into the shares of a third party (see Chapter 9).

See Section 12.4 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.
12.3.3 Conversion Upon the Issuer’s Exercise of a Call Option

12.3.3.1 General

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-11</strong> An entity may issue equity securities to settle a debt instrument that was not otherwise currently convertible but became convertible upon the issuer’s exercise of a call option when the issuance of equity securities is pursuant to the instrument’s original conversion terms. This Subtopic provides related guidance.</td>
</tr>
<tr>
<td><strong>40-4A</strong> The guidance in paragraphs 470-20-40-5 through 40-10 does not apply to debt instruments that are within the scope of the Cash Conversion Subsections of Subtopic 470-20.</td>
</tr>
<tr>
<td><strong>40-5</strong> The following guidance addresses accounting for the issuance of equity securities to settle a debt instrument (pursuant to the instrument’s original conversion terms) that became convertible upon the issuer’s exercise of a call option:</td>
</tr>
<tr>
<td>a. Substantive conversion feature. If the debt instrument contained a substantive conversion feature as of its issuance date, the issuance of equity securities shall be accounted for as a conversion. That is, no gain or loss shall be recognized related to the equity securities issued to settle the instrument.</td>
</tr>
<tr>
<td>b. No substantive conversion feature. If the debt instrument did not contain a substantive conversion feature as of its issuance date (as defined in paragraphs 470-20-30-9 through 30-12), the issuance of equity securities shall be accounted for as a debt extinguishment. That is, the fair value of the equity securities issued should be considered a component of the reacquisition price of the debt.</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 (see Section 12.3.3.2).

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 9.3). 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 (see Section 12.3.2) 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.
### Chapter 12 — Debt Conversions

#### Convertibility of Debt Instrument

<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>

This guidance does not apply to any of the following transactions:

- A conversion that represents a TDR as defined in ASC 470-60 (see Chapter 11).
- Induced conversions as described in ASC 470-20 (see Section 12.3.4).
- A conversion that occurs in accordance with the terms of a share-settled redemption feature (see Section 8.4.7.2.5).
- An exchange of debt into the shares of a third party (see Chapter 9).
- 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 12.6).

#### 12.3.3.2 Determining Whether a Conversion Feature Is Substantive

**ASC 470-20 — Glossary**

**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.

**ASC 470-20**

**40-6** 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.

**40-7** 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.

**40-8** 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.
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.

In evaluating whether a conversion option is substantive as of the debt’s issuance date, an issuer considers the assumptions that were made and the marketplace information that was available as of that date even if the assessment is performed subsequently. 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 currently has a reasonable possibility of becoming exercisable would not be considered substantive if, as of the instrument’s issuance date, its exercise was 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), an issuer 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 greater 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.

### 12.3.3.3 Illustrations

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

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

55-67 This Example Illustrates an instrument subject to the guidance in paragraphs 470-20-40-5 through 40-9.

55-68 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 (the “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.

Since the holder does not have the ability to convert the CoCo debt before the issuer calls it (because the market price trigger is not met), the transaction is evaluated on the basis of the guidance in ASC 470-20-40-5 on conversions that occur upon the issuer’s exercise of a call option. If the feature had been substantive at issuance, the conversion would have been accounted for as a conversion (see Section 12.3.2). If the feature had been nonsubstantive at issuance, the conversion would have been accounted for as an extinguishment (see Section 9.3).

If the facts were altered so that the market-price trigger had been met when the issuer exercised its call option, the guidance in ASC 470-20-40-5 on conversions that occur upon the issuer’s exercise of a call option would not have applied because the holder already had an unconditional right to elect to convert the debt when the issuer chose to call it. In those circumstances, the conversion would have been 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 that guidance. For example, 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</th>
<th>Subject to an Evaluation Under ASC 470-20-40-5?</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scenario 1</strong></td>
<td>No. “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].”</td>
<td>“The carrying amount of the debt is credited to equity, and no gain or loss is recognized.”</td>
</tr>
<tr>
<td>“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.”</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Scenario 2</strong></td>
<td>Yes. “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.”</td>
<td>Because the conversion feature was substantive at issuance, “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.”</td>
</tr>
<tr>
<td>“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.”</td>
<td></td>
<td></td>
</tr>
<tr>
<td>“Based on an analysis of the effective annual interest rate per the terms of the CoCo relative to the effective annual rate that the issuer estimates it could have obtained on a similar non-convertible instrument of an equivalent term, the issuer concludes that, upon issuance, the embedded conversion feature is substantive (that is, it is reasonably possible that the conversion feature will affect the settlement of the instrument).”</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Scenario 3</strong></td>
<td>Yes. “When the issuer exercised its call option on January 1, 2024, 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.”</td>
<td>Because the conversion feature was substantive at issuance, “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.”</td>
</tr>
<tr>
<td>“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.”</td>
<td></td>
<td></td>
</tr>
<tr>
<td>“Based on an analysis of the effective annual interest rate per the terms of the CoCo relative to the effective annual rate that the issuer estimates it could have obtained on a similar nonconvertible instrument of an equivalent term, the issuer concludes that, upon issuance, the embedded conversion feature is substantive (that is, it is reasonably possible that the conversion feature will affect the settlement of the instrument).”</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Further, EITF Issue 05-1, Issue Summary 1, Supplement 1 (May 27, 2005), contains the examples below.

<table>
<thead>
<tr>
<th>Example</th>
<th>Subject to an Evaluation Under ASC 470-20-40-5?</th>
</tr>
</thead>
</table>
| **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.”

<table>
<thead>
<tr>
<th>Subject to an Evaluation Under ASC 470-20-40-5?</th>
</tr>
</thead>
<tbody>
<tr>
<td>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].”</td>
</tr>
</tbody>
</table>

| **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.”

<table>
<thead>
<tr>
<th>Subject to an Evaluation Under ASC 470-20-40-5?</th>
</tr>
</thead>
<tbody>
<tr>
<td>See individual scenarios below.</td>
</tr>
</tbody>
</table>

| **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.”

<table>
<thead>
<tr>
<th>Subject to an Evaluation Under ASC 470-20-40-5?</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
### 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."

### Example 2, Scenario 3

*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.*

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.

### Example 2, Scenario 4

*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.*

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."

### 12.3.4 Induced Conversions

#### 12.3.4.1 Scope

**ASC 470-20**

05-10 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.
ASC 470-20 (continued)

40-13 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:

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)

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.

40-14 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.

40-15 The changed terms may involve any of the following:

a. A reduction of the original conversion price thereby resulting in the issuance of additional shares of stock

b. An issuance of warrants or other securities not provided for in the original conversion terms

c. 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.

For various reasons, such as to reduce interest costs or improve debt-equity ratios, an issuer may seek to induce debt holders to promptly convert convertible debt into equity shares under changed conversion terms that are effective for a limited period and involve additional consideration. That is, the issuer may make an “inducement offer.” The additional consideration offered can take any form (e.g., reduced conversion price, issuance of warrants or other securities, issuance of other noncash assets, payment of cash).

If convertible debt is converted in accordance with an inducement offer that meets the conditions described above, neither conversion only accounting (as described in Section 12.3.2) nor extinguishment accounting (as described in Section 9.3) applies; instead, the issuer must recognize an inducement expense upon the conversion. Such accounting applies to conversions that have all of the following characteristics:

- The debt's original terms 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”).
To induce prompt conversion, the inducement offer contained an exercisability period that was limited. 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 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 Chapter 10).

The convertible debt was converted under the revised conversion terms.

For each converted instrument, all equity securities that were issuable in accordance with the instrument’s original conversion terms were in fact issued (i.e., the conversion can result in the issuance of additional equity shares but cannot result in the issuance of fewer equity shares than would be issued in accordance with the original conversion privileges).

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 (see Section 12.3.2).
- 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 for the purpose of inducing conversion (e.g., subjective modification provisions; 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.

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 the EITF’s example, if the debtor accepts one of the offers, it must apply induced conversion accounting 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 the debt securities in the open market (at a significant discount from face value) and approaches the debtor to increase the conversion terms.”

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 9.3) 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.

12.3.4.2 Recognition and Measurement

**ASC 470-20**

| 40-16 | 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. |
| 40-17 | 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. |

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, 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 FASB Statement 84, the FASB explains its rationale for requiring entities to recognize a cost for the additional consideration issued:

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, when applying the requirement to recognize and measure an inducement expense, an entity 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]).”

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**Example 12-1**

**Recognition of Inducement Loss**

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).

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**12.3.4.3 Illustrations**

**ASC 470-20**

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

55-1 The following Cases illustrate application of the guidance in paragraph 470-20-40-16 to induced conversions of convertible securities:

a. Reduced conversion price for conversion before determination date, increase in bond fair value (Case A)

b. Reduced conversion price for conversion before determination date, decrease in bond fair value (Case B).

55-2 For simplicity, the face amount of each security is assumed to be equal to its carrying amount in the financial statements (that is, no original issue premium or discount exists).

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

55-3 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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</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 privileges</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 privileges: $1,600

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>Value of securities issued</th>
<th>$600</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of securities issuable pursuant to original conversion privileges</td>
<td>480</td>
</tr>
<tr>
<td>Fair value of incremental consideration</td>
<td>$120</td>
</tr>
</tbody>
</table>

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: $12 per share
- Value of securities issued: $600

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: $12 per share
- Value of securities issuable pursuant to original conversion privileges: $480

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>Convertible debt</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<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.

### 12.4 Convertible Debt With a Bifurcated Embedded Conversion Feature

The guidance in U.S. GAAP does not clearly address whether conversion or extinguishment accounting applies to a conversion in situations in which the conversion feature has been bifurcated as a derivative instrument under ASC 815-15. Therefore, as discussed in the example below, it may be acceptable to apply either type of accounting. Similarly, since there is no clear guidance in U.S. GAAP on whether inducement accounting applies to such a conversion, it may be acceptable to apply either inducement accounting (because of the lack of an explicit scope exception; see Section 12.3.4) or extinguishment accounting.
Example 12-2

Accounting for Convertible Debt With a Bifurcated Conversion Option That 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.

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).
Example 12-2 (continued)

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 effected 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.

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:

- Debt host liability: 950
- Conversion option liability: 400
- Common stock/APIC: 1,350
Example 12-2 (continued)

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:

- Interest expense 50
- Debt host liability 50
- Debt host liability 1,000
- Conversion option liability 400
- Common stock/APIC 1,400

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.

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).
Example 12-2 (continued)

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 the views of the staff of the SEC's 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. However, 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 analysis 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.

12.5 Convertible Debt With a Separated Equity Component Other Than a BCF or CCF

ASC 815-15-40-1 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.

Even if a convertible debt instrument does not contain a separately recognized equity component under the BCF or CCF guidance in ASC 470-20 (see Sections 12.6 and 12.7), an equity component may be recognized after issuance if the issuer (1) reclassifies to equity an embedded conversion feature that was previously classified as an embedded derivative liability or (2) modifies or exchanges the convertible debt instrument in a transaction that does not result in extinguishment but in which the fair value of the embedded conversion option is increased (see Section 10.4.3.3.1).

ASC 815-15-40-1 addresses the accounting for scenarios 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. Under that guidance, any remaining unamortized discount upon conversion is immediately recognized as interest expense.
A convertible debt instrument that does not contain a separately recognized equity component under the BCF or CCF guidance in ASC 470-20 may contain an equity component that resulted from a previous modification or exchange that increased the conversion option’s fair value. 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 12.7) and (2) a separately recognized equity component that resulted from a previous reclassification of the embedded conversion option from a liability to equity, 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.

12.6 Convertible Debt Within the Scope of the CCF Guidance in ASC 470-20

12.6.1 General

<table>
<thead>
<tr>
<th>ASC 470-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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:</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td>b. Allocate the fair value of the consideration transferred to the holder between the liability and equity components of the original instrument as follows:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>2. Recognize in the statement of financial performance as a gain or loss on debt extinguishment any difference between (i) and (ii):</td>
</tr>
<tr>
<td>i. The consideration attributed to the liability component.</td>
</tr>
<tr>
<td>ii. The sum of both of the following:</td>
</tr>
<tr>
<td>01. The net carrying amount of the liability component</td>
</tr>
<tr>
<td>02. Any unamortized debt issuance costs.</td>
</tr>
<tr>
<td>3. Allocate the remaining settlement consideration to the reacquisition of the equity component and recognize that amount as a reduction of stockholders’ equity.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
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 as a result of:

- 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.
12.6.2 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.

As discussed in Section 12.3.4, to induce conversion of convertible debt instruments before a specified date, 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 requirements related to induced conversions of convertible debt within the scope of the CCF guidance differ from those for induced conversions of traditional convertible debt (see Section 12.3.4). 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 perform the following two steps in accounting 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 on which the inducement offer is accepted by the convertible debt holder (such as the conversion date or the date on which the holder enters into a binding agreement to convert, as applicable; see Section 12.3.4 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. In other words, 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.

Sometimes, 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 such consideration between the liability and equity components of the original instrument. We believe that in determining the debt extinguishment gain or loss, the issuer cannot allocate an amount greater than the fair value of consideration issuable under the original terms.

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). 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.

Example 12-3

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


**Example 12-3 (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 minus B)</strong></td>
<td>$500</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 minus B)</strong></td>
<td>$110</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>

### 12.7 Convertible Debt With a Recognized BCF

#### 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:

- The discount originated by the beneficial conversion option accounting under paragraph 470-20-25-5
- 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. For a convertible debt instrument, the amount is recognized as interest expense. (Note that this is different from the treatment of any unamortized discount on traditional convertible debt, which is credited to equity; see Section 12.3.2.)

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 12.3.4), 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. The sum of the adjusted carrying amount and the inducement expense would be credited to equity to reflect the shares issued.

This guidance does not apply to any of the following:

- A conversion that represents a TDR (see Chapter 11).
- 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 12.3.3). 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 9.3).
- A settlement of debt that involves a variable number of the issuer’s equity shares equal in value to the amount of the debt (see Section 9.3.3).
- A conversion that occurs in accordance with the terms of a share-settled redemption feature (see Section 8.4.7.5.2).
- An exchange of debt into the shares of a third party.

### 12.8 Interest Forfeiture

**ASC 470-20**

| 05-9 | 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). |
| 35-11 | 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. |
| 40-11 | 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. |
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 (see Section 6.2). If convertible debt does not contain a bifurcated embedded conversion feature under ASC 815-15 (see Section 12.4) or a separately recognized equity component (see Sections 12.5, 12.6, and 12.7), 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.
Chapter 13 — Balance Sheet Classification

13.1 Background
Many entities prepare a classified balance sheet in which assets and liabilities are grouped on the basis of whether they are current or noncurrent. ASC 470-10 contains guidance related to such classification, whereas ASC 210-10 contains more broadly applicable requirements related to an entity’s classification of assets and liabilities as either current or noncurrent.

Changing Lanes
The FASB has an active project on its agenda to simplify the guidance on the classification of debt as current or noncurrent under ASC 470-10. On September 12, 2019, the FASB issued a proposed ASU, which represented a revised version of the proposed ASU on the same topic that it had issued on January 10, 2017. The Board’s proposed approach is to replace the current, fact-specific guidance with a principle that focuses on a debt arrangement’s contractual terms as of the balance sheet date. Under an exception to the proposed classification principle, an entity would not classify debt as current solely because of a debt covenant violation that gives the lender the right to demand repayment of the debt, as long as the lender waives its right before the financial statements are issued (or are available to be issued) and certain conditions are met. In addition, the proposed ASU’s application guidance would clarify how covenant violations, covenant waivers, post-balance-sheet refinancing transactions, and subjective acceleration clauses (SACs) affect debt classification. For more information about the proposal, see Deloitte’s September 19, 2019, Heads Up.

13.2 Scope
13.2.1 Entities

<table>
<thead>
<tr>
<th>ASC 470-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-4</strong> . . . The balance sheets of most entities show separate classifications of current assets and current liabilities (commonly referred to as classified balance sheets) permitting ready determination of working capital.</td>
</tr>
<tr>
<td><strong>15-2</strong> The guidance in this Subtopic that relates to separate classification of current assets and current liabilities (that is, a classified balance sheet) applies only when an entity is preparing a classified balance sheet for financial accounting and reporting purposes.</td>
</tr>
</tbody>
</table>
The guidance in ASC 470-10 on the balance sheet classification of debt applies to debtors that present a classified balance sheet, which (as indicated in ASC 210-10-05-4) includes most debtors. Further, Regulation S-X, Rule 5-02 (reproduced in ASC 210-10-S99-1), requires SEC registrants within the scope of that rule (i.e., commercial and industrial companies) to present a classified balance sheet when filing financial statements with the SEC. However, that requirement does not apply to registered investment companies, employee stock purchase, savings and similar plans, insurance companies, bank holding companies and banks, brokers and dealers, and real estate entities.

13.2.2 Instruments
ASC 210-10 contains broadly applicable guidance on the classification of assets and liabilities as current or noncurrent. Further, ASC 470-10 requires entities to classify the following types of obligations as current or noncurrent on a classified balance sheet:

- Debt repayable on demand (see Section 13.4).
- Long-term debt that includes covenants that, if violated, make the debt repayable (see Section 13.5).
- Long-term obligations that contain a SAC (see Section 13.6).
- Short-term obligations expected to be refinanced on a long-term basis (see Section 13.7).
- Revolving-credit arrangements, including those with lockbox arrangements (see Section 13.8).
- Increasing-rate debt (see Section 13.9).

For discussion of the application of the classification guidance to convertible debt, see Section 13.10.

13.3 General
13.3.1 Background
To determine whether debt should be classified as current or noncurrent, an entity must apply the guidance in ASC 470-10 (see Section 13.3.2) and ASC 210-10 (see Section 13.3.3). See Section 13.3.4 for definitions of certain key terms that are used in ASC 210-10.

13.3.2 Debt Classification Guidance in ASC 470-10
ASC 470-10 does not establish a uniform principle for classifying debt as current or noncurrent; instead, it consists of a patchwork of rules and exceptions. One requirement, which is subject to exceptions, is that liabilities that are scheduled to mature or that the creditor could force the debtor to repay within one year (or the operating cycle, if longer) after the balance sheet date should be treated as short-term obligations even if they are not expected to be settled within that period.

Accordingly, the following types of debt must be classified as current liabilities unless (1) their settlement will not require the use of current assets or the creation of other current liabilities (see Section 13.3.3.4) or (2) a specific exception applies:

- Debt that is contractually scheduled to mature within one year (or the operating cycle, if longer) after the balance sheet date (see Section 13.3.4.2).
- Any portion of long-term debt that is contractually scheduled to mature within one year (or the operating cycle, if longer) after the balance sheet date, such as the current portion of an amortizing loan for which the principal is paid down over the loan’s life (see Section 13.3.3.4).
• Debt that contractually is due on demand as of the balance sheet date or that will become payable on demand within one year (or the operating cycle, if longer) after the balance sheet date, including puttable debt (see Section 13.4) and debt that has become payable on demand because of a covenant violation (see Section 13.5).

However, short-term obligations are classified as noncurrent liabilities if:

• A debtor has violated an objectively verifiable debt covenant as of the balance sheet date that makes an otherwise long-term obligation due on demand or payable on demand within one year of the balance sheet date and the creditor grants a waiver before the financial statements are issued (or available to be issued) or a grace period applies (see Section 13.5.3).
• A debtor has the intent and ability to refinance a short-term obligation on a long-term basis (see Section 13.7).

In some scenarios, a debtor is required to consider expectations about whether the creditor will accelerate a debt’s due date. If long-term debt contains a SAC and is not payable on demand or within one year (or the operating cycle, if longer) after the balance sheet date, the debtor must evaluate whether the SAC is likely to be invoked to determine whether the debt is classified as current or noncurrent (see Section 13.6). Further, special guidance applies to revolving debt with a lockbox arrangement (see Section 13.8) and to increasing-rate debt (see Section 13.9), and there are some unique issues associated with the treatment of convertible debt (see Section 13.10). For a discussion of the classification of long-term obligations that are repaid or that the debtor intends to repay after the balance sheet date, see Section 13.11.

The table below provides an overview of the classification of different types of debt as current or noncurrent under ASC 210-10 and ASC 470-10. Note, however, that the appropriate classification depends on the application of GAAP to the specific facts and circumstances.

<table>
<thead>
<tr>
<th>Noncurrent</th>
<th>Current¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Long-term debt that does not contain a SAC and for which no covenant violation has occurred (see Section 13.3.4.3).</td>
<td>• Debt that is scheduled to mature within one year (or the operating cycle, if longer) after the balance sheet date (see Section 13.3.4.2).</td>
</tr>
<tr>
<td>• Long-term debt that contains a SAC and is unlikely to be triggered (see Section 13.6).</td>
<td>• Any portion of long-term debt that is scheduled to mature within one year (or the operating cycle, if longer) after the balance sheet date (see Section 13.3.3.4).</td>
</tr>
<tr>
<td>• Long-term debt that became payable on demand or within one year (or the operating cycle, if longer) after the balance sheet date because of a covenant violation if the creditor granted a waiver of the covenant violation that meets certain criteria (see Section 13.5.3.2 and 13.5.3.3).</td>
<td>• Debt that is due on demand or that will become payable on demand within one year (or the operating cycle, if longer) after the balance sheet date (see Section 13.4).</td>
</tr>
<tr>
<td>• Long-term debt that will become payable on demand or within one year (or the operating cycle, if longer) because of a covenant violation if the debt contains a grace period and it is probable that the violation will be cured within that period (see Section 13.5.3.4).</td>
<td>• Long-term debt that has become payable on demand or within one year (or the operating cycle, if longer) after the balance sheet date because of a covenant violation (if no exception applies; see Section 13.5.1).</td>
</tr>
</tbody>
</table>

¹ Unless an item must be classified as noncurrent because the refinancing exception discussed in Section 13.7 applies.
### 13.3.3 Classification Guidance in ASC 210-10

#### 13.3.3.1 Background

<table>
<thead>
<tr>
<th>ASC 210-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-4</strong> The Overall Subtopic provides general guidance on the classification of current assets and current liabilities and discusses the determination of working capital. The balance sheets of most entities show separate classifications of current assets and current liabilities (commonly referred to as classified balance sheets) permitting ready determination of working capital.</td>
</tr>
</tbody>
</table>

This section briefly summarizes the various definitions and guidance in ASC 210-10 that could be relevant to the classification of debt as current or noncurrent.

#### 13.3.3.2 Working Capital

<table>
<thead>
<tr>
<th>ASC 210-10 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Working Capital</strong></td>
</tr>
<tr>
<td>Working capital (also called net working capital) is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total entity capital that constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the entity.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 210-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-5</strong> Financial position, as it is reflected by the records and accounts from which the statement is prepared, is revealed in a presentation of the assets and liabilities of the entity. In the statements of manufacturing, trading, and service entities, these assets and liabilities are generally classified and segregated; if they are classified logically, summations or totals of the current or circulating or working assets (referred to as current assets) and of obligations currently payable (designated as current liabilities) will permit the ready determination of working capital.</td>
</tr>
</tbody>
</table>
The classification of assets and liabilities as current is intended to permit a financial statement user to readily determine an entity's working capital. In practice, metrics and ratios that are computed on the basis of balance sheet measures of working capital or components thereof are often used in financial statement analysis and referenced in debt covenants.

### 13.3.3.3 Operating Cycle

**ASC 210-10 — Glossary**

**Operating Cycle**
The average time intervening between the acquisition of materials or services and the final cash realization constitutes an operating cycle.

*ASC 210-10*

05-6 The ordinary operations of an entity involve a circulation of capital within the current asset group. Cash is expended for materials, finished parts, operating supplies, labor, and other factory services, and such expenditures are accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again.

45-3 A one-year time period shall be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within a year. However, if the period of the operating cycle is more than 12 months, as in, for instance, the tobacco, distillery, and lumber businesses, the longer period shall be used. If a particular entity has no clearly defined operating cycle, the one-year rule shall govern.

Most entities use a one-year period as the basis for distinguishing between current and noncurrent items. Under ASC 210-10-45-3, an entity that has no clearly defined operating cycle or more than one operating cycle within a year must use the one-year time frame. However, if the entity's operating cycle is greater than one year, it should base the distinction on the operating cycle. ASC 210-10-45-3 suggests that a period longer than a year may be appropriate, for example, in the tobacco, distillery, and lumber businesses. The operating cycle is the average amount of time it takes an entity to acquire materials or services, convert those items into finished goods or services, and collect cash from the sale of those goods or services.

### 13.3.3.4 Current Assets and Current Liabilities

**ASC 210-10 — Glossary**

**Current Assets**
Current assets is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. See paragraphs 210-10-45-1 through 45-4.

**Current Liabilities**
Current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. See paragraphs 210-10-45-5 through 45-12.
Obligations in the Operating Cycle

45-8 As a balance sheet category, the classification of current liabilities generally includes obligations for items that have entered into the operating cycle, such as the following:

a. Payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale.

b. Collections received in advance of the delivery of goods or performance of services. Examples of such current liabilities are obligations resulting from advance collections on ticket sales, which will normally be liquidated in the ordinary course of business by the delivery of services. On the contrary, obligations representing long-term deferments of the delivery of goods or services would not be shown as current liabilities. Examples of the latter are the issuance of a long-term warranty or the advance receipt by a lessor of rental for the final period of a 10 year lease as a condition to execution of the lease agreement.

c. Debts that arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes.

Other Liabilities

45-9 Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, are also generally included, such as the following:

a. Short-term debts arising from the acquisition of capital assets

b. Serial maturities of long-term obligations

c. Amounts required to be expended within one year under sinking fund provisions

d. Agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons. Loans accompanied by pledge of life insurance policies would be classified as current liabilities if, by their terms or by intent, they are to be repaid within 12 months. The pledging of life insurance policies does not affect the classification of the asset any more than does the pledging of receivables, inventories, real estate, or other assets as collateral for a short-term loan. However, when a loan on a life insurance policy is obtained from the insurance entity with the intent that it will not be paid but will be liquidated by deduction from the proceeds of the policy upon maturity or cancellation, the obligation shall be excluded from current liabilities.

Because the definition of working capital (see Section 13.3.3.2) refers to an entity's operating cycle (see Section 13.3.3.3), current assets are limited to those assets that are “reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.” Similarly, current liabilities are limited to those obligations “that have entered into the operating cycle,” such as payables for goods or services that are used in the entity's production process (see ASC 210-10-45-8), or “whose regular and ordinary liquidation is expected to occur within a relatively short period of time,” such as short-term debt and the current portion of long-term obligations (see ASC 210-10-45-9).

In the application of this guidance to debt obligations, a debtor must comply with the more specific requirements in ASC 470-10. As discussed in Section 13.3.2, debt that is scheduled to mature or that the creditor could force the debtor to repay within one year (or the operating cycle, if longer) after the balance sheet date is generally classified as a current liability under ASC 470-10 even if it is not expected to be settled within a relatively short period.

Current liabilities are limited to obligations whose settlement is “reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.” Accordingly, short-term obligations that must be settled in the debtor's nonredeemable equity shares (e.g., certain mandatorily convertible shares) do not meet the definition of current liabilities.
13.3.3.5 Funds Set Aside for the Liquidation of Long-Term Debt

ASC 210-10

45-4 The concept of the nature of current assets contemplates the exclusion from that classification of such resources as the following:

a. Cash and claims to cash that are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated for the liquidation of long-term debts. Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes shall also, under this concept, be excluded from current assets. However, if such funds are considered to offset maturing debt that has properly been set up as a current liability, they may be included within the current asset classification. . . .

45-12 The current liability classification is not intended to include debts to be liquidated by funds that have been accumulated in accounts of a type not properly classified as current assets, or long-term obligations incurred to provide increased amounts of working capital for long periods.

If a debtor segregates funds for the purpose of settling long-term debt, those funds should be classified as noncurrent assets in accordance with ASC 470-10-45-4(a). Footnote 1 of FASB Statement 6 (not codified) indicates that “funds obtained on a long-term basis prior to the balance sheet date would be excluded from current assets if the obligation to be liquidated is excluded from current liabilities.” However, funds that are set aside to pay a current liability would be classified as current assets.

13.3.4 Other Key Terms

13.3.4.1 Background

This section discusses key terms in ASC 470-10 that are used to determine the appropriate classification of debt as current or noncurrent.

13.3.4.2 Short-Term Obligations

ASC 210-10 — Glossary

Short-Term Obligations

Short-term obligations are those that are scheduled to mature within one year after the date of an entity’s balance sheet or, for those entities that use the operating cycle concept of working capital described in paragraphs 210-10-45-3 and 210-10-45-7, within an entity’s operating cycle that is longer than one year.

A short-term obligation is one that is “scheduled to mature within one year” (or the operating cycle, if longer) after the balance sheet date. It also includes any portion of long-term debt that is contractually scheduled to mature within one year (or the operating cycle, if longer) after the balance sheet date, such as the current portion of an amortizing loan for which the principal is paid down over the loan’s life (see Section 13.3.3.4). Under ASC 470-10-45-14, an obligation that is repayable on demand or within one year (or the operating cycle, if longer) after the balance sheet date would also be a short-term obligation (see Section 13.4). Similarly, an obligation that has become repayable on demand or within one year (or the operating cycle, if longer) after the balance sheet date because of a covenant violation would be a short-term obligation under that guidance (see Section 13.5). The term “short-term obligation” does not have the same meaning as “current liability” because some short-term obligations qualify as noncurrent liabilities in accordance with the guidance on refinancing arrangements and covenant waivers.
13.3.4.3 Long-Term Obligations

**ASC 470-10 — Glossary**

**Long-Term Obligations**

Long-term obligations are those scheduled to mature beyond one year (or the operating cycle, if applicable) from the date of an entity’s balance sheet.

Under ASC 470-10, a long-term obligation is one that is “scheduled to mature beyond one year” (or the operating cycle, if longer) after the balance sheet date. It excludes any portion of long-term debt that is contractually scheduled to mature within one year (or the operating cycle, if longer) after the balance sheet date, such as the current portion of an amortizing loan for which the principal is paid down over the loan’s life (see Section 13.3.3.4). Under ASC 470-10-45-2, an obligation that is repayable on demand or within one year (or the operating cycle, if longer) after the balance sheet date would not be considered a long-term obligation (see Section 13.4). Similarly, an obligation that has become repayable on demand or within one year of the balance sheet date (or the operating cycle, if longer) because of a covenant violation would not be considered a long-term obligation (see Section 13.5). The term “long-term obligation” does not have the same meaning as “noncurrent liability” because some long-term obligations must be classified as current liabilities (see Section 13.6).

13.3.4.4 Callable Obligations

**ASC 470-10 — Glossary**

**Callable Obligation**

An obligation is callable at a given date if the creditor has the right at that date to demand, or to give notice of its intention to demand, repayment of the obligation owed to it by the debtor.

ASC 470-10 describes an obligation as “callable” if “the creditor has the right at that date to demand, or to give notice of its intention to demand, repayment.” In practice, such debt is often described as debt with an embedded put option or a demand or acceleration feature. Further, ASC 815 describes such a feature as a put option, not as a call option (see, for example, ASC 815-15-55-26 through 55-53). Under ASC 815, an embedded call option is an option held by the debtor, not the creditor (see, for example, ASC 815-15-25-37 and 25-38, and ASC 815-15-25-43). To reduce the potential for confusion related to the terminological inconsistency between ASC 470-10 and ASC 815-15, this Roadmap generally refers to debt that is described as callable under ASC 470-10 as debt with a demand or put feature (see also Section 13.4.2).

13.3.4.5 Violation of a Provision

**ASC 470-10 — Glossary**

**Violation of a Provision**

The failure to meet a condition in a debt agreement or a breach of a provision in the agreement for which compliance is objectively determinable, whether or not a grace period is allowed or the creditor is required to give notice of its intention to demand repayment.
Drawing a distinction between significant violations of critical conditions and technical violations is not practicable. A violation that a debtor considers to be technical may be considered critical by the creditor. Furthermore, a creditor may choose to use a technical violation as a means to withdraw from its lending relationship with the debtor. If the violation is considered insignificant by the creditor, then the debtor should be able to obtain a waiver as discussed in the preceding paragraph.

ASC 470-10-45-11 provides two exceptions to the requirements related to current classification (see Section 13.5.3). The reference in that guidance to a debtor’s “violation of a provision” includes any objectively determinable provision that accelerates the debt’s maturity date or otherwise makes the debt payable on demand (or will make the debt payable on demand unless cured within a specified grace period) to protect the creditor from an adverse issuer-specific credit event. In practice, the contractual terms of debt arrangements often describe such covenant violations as events of default. Examples of debt covenants that, if violated, may cause debt to be repayable on demand include those related to:

- Working capital requirements.
- Minimum current ratios.
- Maximum debt-to-equity ratios.
- The issuance of an unqualified audit opinion (e.g., within 90 days of year-end).
- Bankruptcy prohibitions.

Whether a credit deterioration occurs in connection with a specific provision that was violated is not relevant. For example, an event of default may not actually be related to a deterioration in the debtor’s credit. That is, to apply the exceptions in ASC 470-10-45-11, a debtor does not have to establish that an event that results in the debt’s becoming payable on demand is associated with a decline in the debtor’s credit standing. However, the provision that was violated must be related to credit. For example, the exceptions in ASC 470-10-45-11 would not apply to provisions under which (1) debt becomes callable solely on the basis of passage of time or (2) cash-settleable convertible debt becomes convertible if a stock price target is triggered (see ASC 470-20-45-3) because both provisions are unrelated to the borrower’s credit risk. In those situations, debt that is payable on demand on the balance sheet date would be classified as a current liability regardless of whether the redemption provision lapses before the financial statements are issued or available to be issued unless the debtor meets the exception for certain refinancing arrangements (see Section 13.7).

ASC 470-10-45-11 does not distinguish between significant covenant violations and minor technical violations that can be easily corrected. As the FASB notes in ASC 470-10-45-12 and paragraph 16 of the Background Information and Basis for Conclusions of FASB Statement 78, it “is not practicable” to draw a distinction between those two types of violations.
Example 13-1

**Debt Callable as a Result of a Change in Control**

On December 15, 20X2, Company ABC issued a 10-year debt instrument that contains a change-in-control provision. Under the terms of the debt instrument, the lender has the ability to demand repayment of the debt upon the occurrence of a change-in-control event. However, the lender’s ability to demand repayment of the debt expires 45 days from the date of the change-in-control event. The debt agreement does not define a change-in-control event as an event of default.

On December 16, 20X4, Company XYZ acquires ABC, triggering a change-in-control event. As a result, on that date and as of ABC’s December 31, 20X4, balance sheet date, the debt was repayable on demand. However, as of February 1, 20X5 (46 days later), the lender had not requested repayment of the debt, and the demand feature therefore expired unexercised. In addition, as of February 1, 20X5, ABC’s financial statements as of and for the year ended December 31, 20X4, were not yet issued (or available to be issued, as discussed in ASC 855-10).

Company ABC has determined that the purpose of the change-in-control feature was to protect the lender from potential adverse credit-related events that could result from a change of control. Therefore, ABC concludes that ASC 470-10-45-11 applies to the change-in-control provision.

As long as ABC is able to objectively and unconditionally determine that the lender’s ability to demand repayment of the debt has lapsed as of or before the date the 20X4 financial statements are issued (or available to be issued), ABC would classify the debt as noncurrent on its balance sheet.

Example 13-2

**Debt Repayable on Lender’s Demand**

On December 15, 20X2, Company SCP issued a 10-year debt instrument that allows the lender to demand repayment of the debt three years after the original issuance date. However, the lender’s ability to demand repayment of the debt expires 60 days from the third anniversary of the debt instrument’s issuance date.

On December 15, 20X5 (the third anniversary of the debt’s issuance date), and as of SCP’s December 31, 20X5, balance sheet date, the debt instrument was payable on demand. On February 14, 20X6, the lender’s right to demand repayment of the debt expired unexercised. In addition, as of February 14, 20X6, the financial statements of SCP as of and for the year ended December 31, 20X5, were not yet issued (or available to be issued, as discussed in ASC 855-10).

Company SCP has determined that the purpose for including the feature in the debt instrument is unrelated to potential adverse credit-related events, and it therefore concludes that applying ASC 470-10-45-11 to the feature is not appropriate. Accordingly, because SCP’s debt is repayable on demand as of the balance sheet date, it would be classified as a current liability under ASC 470-10-45-10 even though the lender ultimately did not exercise its right (see Section 13.4).

The guidance in ASC 470-10-45-11 related to objectively determinable covenant violations differs from that for SACs. Whereas the likelihood that the creditor will demand repayment is a factor in the evaluation of whether a SAC that has not been invoked triggers current classification of a long-term obligation, such likelihood usually does not affect the analysis of an objectively determinable covenant that has not been violated (see Section 13.5.2.2).

Nevertheless, the likelihood of a repayment demand is a factor in an entity’s evaluation of whether it can apply one of the exceptions to current classification for an objectively determinable covenant that has been violated. That is, before it can apply the covenant waiver exception, a debtor must assess whether it will comply with the covenant as of measurement dates that are within the next 12 months (see Section 13.5.3.3). Likewise, before it can apply the grace period exception, a debtor must assess whether it is probable that it will cure the violation within the grace period (see Section 13.5.3.4).
13.3.4.6 Subjective Acceleration Clauses

**ASC 470-10 — Glossary**

**Subjective Acceleration Clause**

A subjective acceleration clause is a provision in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, if the debtor fails to maintain satisfactory operations or if a material adverse change occurs).

The contractual terms of debt obligations often include some debt covenants that are objectively determinable (e.g., nonpayment of a debt obligation) and others that require a subjective evaluation (e.g., failure to maintain satisfactory operations or a material adverse change). A SAC is a contractual term in a debt agreement that permits the creditor to accelerate the repayment of the debt under conditions that are not objectively determinable. A subjective cancellation clause (which is also considered a SAC and referred to as such herein) is a contractual term in a financing agreement that permits the potential creditor or investor to terminate the financing agreement on terms that are not objectively determinable.

A subjective condition is one that may be evaluated differently by the parties to the agreement. Examples of subjective conditions include the following:

- At all times, the debtor’s financial condition and results of operations must be satisfactory to the creditor.
- There will be an event of default if there is a material impairment of the collateral on a debt obligation (and “material” is not objectively defined).
- The creditor must have reasonably determined that any event that materially adversely affects a debt instrument’s collectibility has not occurred (i.e., a material adverse change clause).
- A deterioration has taken place in the quality of the servicing of receivables used as collateral on a debt instrument that the creditor, in its sole discretion, determines to be material.

An objectively determinable condition is one that would not be evaluated differently by the parties to the agreement. Examples include but are not limited to specified financial ratios, a change-of-control provision based on a specified percentage change in capital ownership of the debtor, and the occurrence of particular events (bankruptcy, restatements, going-concern audit opinions, etc.). If a debt contract defines an “adverse change” in an objectively determinable manner (e.g., a maximum decrease in reported earnings), it would be considered an objectively determinable condition.

Some debt and financing agreements (e.g., revolving-debt agreements) contain a material adverse change clause that applies only upon the initial execution of the agreement. For example, a creditor might require a debtor to represent that no material adverse change has occurred in the period between the most recent financial statements and the initial execution of the agreement as a precondition for entering into the agreement. However, the agreement might not give the creditor a right to demand repayment or cancel the agreement if the debtor experiences a material adverse change after the agreement’s initial execution. In this case, the agreement does not contain a subjective acceleration or cancellation provision since it does not permit the creditor to demand repayment or cancel the agreement unless it can demonstrate that the debtor’s initial representation was false.

Conversely, an agreement is considered to contain a subjective acceleration or cancellation clause if the creditor is able to demand repayment or reject a funding request if it determines that a material adverse change has occurred after the initial execution of the agreement. For example, a financing agreement would be considered to contain a subjective cancellation provision if it requires the debtor to represent that no material adverse change has occurred each time it borrows under the agreement.
An acceleration or cancellation clause in a debt or financing agreement may include both objectively determinable and subjective conditions that must be met before the creditor is permitted to demand repayment or cancel the agreement. For example, a financing agreement might require the debtor to represent that it has not, without the creditor’s prior written consent, amended, restated, or otherwise modified any contracts that serve as collateral under the agreement in a manner that would reasonably be expected to have a material adverse effect. Such a clause should be evaluated as an objectively determinable condition under ASC 470-10 since the creditor cannot demand repayment or cancel the agreement unless the objectively determinable condition is met (i.e., the debtor has amended, restated, or otherwise modified such contracts without the creditor’s prior written consent).

### 13.3.4.7 “Traditional” Lockbox Arrangement

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<tr>
<th>ASC 470-10 — Glossary</th>
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<tr>
<td><strong>Lock-Box Arrangement</strong></td>
</tr>
<tr>
<td>An arrangement with a lender whereby the borrower’s customers are required to remit payments directly to the lender and amounts received are applied to reduce the debt outstanding. A lock-box arrangement refers to any situation in which the borrower does not have the ability to avoid using working capital to repay the amounts outstanding. That is, the contractual provisions of a loan arrangement require that, in the ordinary course of business and without another event occurring, the cash receipts of a debtor are used to repay the existing obligation.</td>
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The terms of some debt obligations contain a “lockbox” arrangement under which the debtor’s customers submit payments for goods or services directly to a special collection account maintained by the creditor. In a “traditional” lockbox arrangement, payments to the lockbox are automatically applied to reduce the outstanding debt. Therefore, a debt arrangement that incorporates a traditional lockbox arrangement is considered a short-term obligation under ASC 470-10 even if the final maturity of the debt is not within one year (or the operating cycle, if longer) after the balance sheet date (see Section 13.8.3.1). In a revolving-debt arrangement, the contractual terms usually permit the debtor to request additional borrowings so that the outstanding balance due under the arrangement remains unchanged (i.e., the debtor draws an amount equal to the daily cash receipts). To determine the appropriate classification of such debt, the debtor must evaluate the right to request additional borrowings under the guidance on refinancing arrangements (see Sections 13.7.4 and 13.8.3.3).

### Connecting the Dots

A contractual provision might meet the definition of a lockbox arrangement even if the terms of the debt do not explicitly refer to it as a lockbox. For example, a contract might refer to a lockbox as a blocked collection account or a deposit account control agreement.
13.3.4.8  **Springing Lockbox Arrangement**

ASC 470-10 — Glossary

**Springing Lock-Box Arrangement**

Some borrowings outstanding under a revolving credit agreement include both a subjective acceleration clause and a requirement to maintain a springing lock-box arrangement, whereby remittances from the borrower’s customers are forwarded to the debtor’s general bank account and do not reduce the debt outstanding until and unless the lender exercises the subjective acceleration clause.

In a springing lockbox arrangement, the debtor has full access to amounts collected from its customers. The creditor is not entitled to the payments, although such amounts may be subject to a security interest in the creditor’s favor. If a triggering event occurs (e.g., the debtor does not pay its debts on time or the creditor exercises a SAC), the arrangement becomes a traditional lockbox under which the payments received from customers are automatically applied to reduce the debtor’s outstanding debt. A springing lockbox arrangement does not prevent a debt instrument from being treated as a long-term obligation (see Section 13.8.3.2).

13.3.4.9  **Financial Statements Are Issued (or Available to Be Issued)**

ASC 855-10 — Glossary

**Financial Statements Are Available to Be Issued**

Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity’s management and corporate governance structure as well as statutory and regulatory requirements.

**Financial Statements Are Issued**

Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP. (U.S. Securities and Exchange Commission [SEC] registrants also are required to consider the guidance in paragraph 855-10-S99-2.)
Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings

SEC Staff Announcement: Issuance of Financial Statements

The following is the text of SEC Staff Announcement: Issuance of Financial Statements.

In considering when financial statements have been issued, the SEC staff observed that Rules 10b-5 and 12b-20 under the Securities Exchange Act of 1934 and General Instruction C(3) to Form 10-K specify that financial statements must not be misleading as of the date they are filed with the Commission. For example, assume that a registrant widely distributes its financial statements but, before filing them with the Commission, the registrant or its auditor becomes aware of an event or transaction that existed at the date of the financial statements that causes those financial statements to be materially misleading. If a registrant does not amend those financial statements so that they are free of material misstatement or omissions when they are filed with the Commission, the registrant will be knowingly filing a false and misleading document. In addition, registrants are reminded of their responsibility to, at a minimum, disclose subsequent events\(^\text{FN1}\) while independent auditors are reminded of their responsibility to assess subsequent events\(^\text{FN2}\) and evaluate the impact of the events or transactions on their audit report.\(^\text{FN3}\)

A registrant and its independent auditor have responsibilities with regard to post-balance-sheet-date subsequent events, as well as the application of authoritative literature applicable to such events. See Topic 855 and AU 560, Subsequent Events, paragraph 3.

Generally, the staff believes that financial statements are “issued” as of the date they are distributed for general use and reliance in a form and format that complies with generally accepted accounting principles (GAAP) and, in the case of annual financial statements, that contain an audit report that indicates that the auditors have complied with generally accepted auditing standards (GAAS) in completing their audit. Issuance of financial statements then would generally be the earlier of when the annual or quarterly financial statements are widely distributed to all shareholders and other financial statement users\(^\text{FN4}\) or filed with the Commission. Furthermore, the issuance of an earnings release does not constitute issuance of financial statements because the earnings release would not be in a form and format that complies with GAAP and GAAS.

\(^{\text{FN1}}\) See AU Section 560, Subsequent Events, paragraphs 5 and 8 and Section 855-10-50.

\(^{\text{FN2}}\) See AU 560 and AU Section 561, Subsequent Discovery of Facts Existing at Date of the Auditor’s Report.

\(^{\text{FN3}}\) See AU Section 530, Dating of the Independent Auditor’s Report, and AU 560, paragraph 9.

\(^{\text{FN4}}\) Posting financial statements to a registrant’s web site would be considered wide distribution to all shareholders and other financial statement users if the registrant uses its web site to disclose information to the public in a manner consistent with the requirements of Regulation FD. See the Commission’s interpretive guidance in Exchange Act Release No. 58288 (Aug. 7, 2008).
13.4 Debt With Early Settlement Feature

13.4.1 Background
This section discusses the classification of debt with early settlement features (such as put and call options), including debt with provisions that (1) permit the creditor to demand early repayment (see Section 13.4.2 below), (2) contingently accelerate the maturity date or contingently permit the debtor to demand early repayment (see Section 13.4.3 below), or (3) permit the debtor to prepay the amount outstanding (see Section 13.4.4). For a discussion of credit-related early settlement features with contingencies, see Section 13.5.

13.4.2 Provisions That Permit the Creditor to Demand Early Repayment

<table>
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<tr>
<th>ASC 470-10</th>
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<tr>
<td>45-9 Loan agreements may specify the debtor’s repayment terms but also enable the creditor, at his discretion, to demand payment at any time. Those loan arrangements may have wording such as either of the following:</td>
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<tr>
<td>a. “The term note shall mature in monthly installments as set forth therein or on demand, whichever is earlier.”</td>
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<tr>
<td>b. “Principal and interest shall be due on demand, or if no demand is made, in quarterly installments beginning on. . . .”</td>
</tr>
<tr>
<td>45-10 The current liability classification shall include obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period. The demand provision is not a subjective acceleration clause as discussed in paragraph 470-10-45-2.</td>
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</table>

Except for certain obligations that are expected to be refinanced on a long-term basis (see Section 13.7), debt that is due on demand or that will become payable on demand within one year after the balance sheet date (or the operating cycle, if longer) should be classified as current even if it is not expected to be repaid within that period. For example, an obligation that is scheduled to mature more than one year after the balance sheet date may contain an embedded put option that permits the investor to put the debt to the issuer at any time or on one or more dates within the next 12 months in exchange for the repayment of the principal and interest amounts owed. Such debt would be classified as current under ASC 470-10-45-10 unless it meets the conditions for debt that is expected to be refinanced on a long-term basis (see Section 13.7).

13.4.3 Provisions That Require or Permit the Creditor to Demand Early Payment Upon a Non-Credit-Related Contingent Event

Some debt obligations become immediately due and payable, or payable within one year (or the operating cycle, if longer) after the balance sheet date, upon the occurrence or nonoccurrence of a specified event (e.g., a put option that becomes exercisable upon a fundamental change). If the contingency is met as of the balance sheet date and is not credit-related, such debt obligations are analyzed as debt that is due on demand or within one year (or the operating cycle, if longer) after the balance sheet date (see Section 13.4.2 above). If, as a result of a discrete event that occurred after the balance sheet date, the contingency is not credit-related and is not met as of the balance sheet date but is met before the financial statements are issued (or available to be issued), it is acceptable to treat the debt as a long-term obligation. For example, noncurrent classification would be appropriate if the triggering event was within the debtor's control (e.g., the entity's decision to sell certain assets after the balance sheet date). In that scenario, the debtor should disclose an acceleration of the debt's due date as a nonrecognized subsequent event under ASC 855-10.
If the contingency is credit-related, the debtor should apply the guidance in ASC 470-10-45-11 on covenant violations that cause the debt to become repayable (see Section 13.5 below) regardless of whether the covenant violation occurred (1) as of the balance sheet date or (2) after the balance sheet date but before the financial statements were issued (or available to be issued).

### 13.4.4 Provisions That Permit the Debtor to Pay Early

Some debt obligations contain call or prepayment options that permit the debtor to prepay the obligation before its maturity date (e.g., at any time, on specified dates, or upon the occurrence or nonoccurrence of a specified event). Generally, such options do not affect the classification of debt as current or noncurrent before it is exercised since the debtor has discretion over whether to exercise the options and could not be contractually forced to repay the debt early because of them. However, if the debtor irrevocably exercises a call or prepayment option before or as of the balance sheet date, the related debt should be classified as current if the debt's repayment will occur within one year (or the operating cycle, if longer) after the balance sheet date. If the debtor exercises a call or prepayment option after the balance sheet date, it should disclose that fact as a nonrecognized subsequent event.

### 13.5 Credit-Related Covenant Violations That Cause Debt to Become Repayable

#### 13.5.1 General

| ASC 470-10-45-11 | Current liabilities shall include long-term obligations that are or will be callable by the creditor either because the debtor's violation of a provision of the debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable. . . . |

If an entity violates an objectively determinable covenant on a long-term debt arrangement, the contractual terms might accelerate the debt's due date or give the creditor the right to accelerate the debt's due date. Long-term debt that has become payable on demand or within one year (or the operating cycle, if longer) after the balance sheet date because of a covenant violation that has occurred as of the balance sheet date or, in the case of credit-related covenants, after the balance sheet date but before the financial statements are issued (or available to be issued) (see Section 13.5.2.2) generally must be classified as current. This is the case even if the creditor has not demanded repayment and there is no indication that it will do so. However, a credit-related covenant violation in a long-term obligation does not trigger current classification if one of the following exceptions in ASC 470-10 applies:

- **Covenant waiver** — The debtor obtains a covenant waiver that meets the requirements in ASC 470-10-45-1 and ASC 470-10-45-11(a) before the financial statements are issued or are available to be issued (see Sections 13.5.3.2 and 13.5.3.3).

- **Grace period** — The debt contains a grace period and it is probable that the violation will be cured within such period (see ASC 470-10-45-11(b) and Section 13.5.3.4).

- **Refinancing arrangement** — The debtor has the intent and ability to refinance the obligation on a long-term basis (see Section 13.7).

For a discussion of the analysis of covenant violations that are not credit-related, see Section 13.4.3.
13.5.2 Scope

13.5.2.1 Background
This section discusses credit-related covenant violations that occur after the balance sheet date but before the financial statements are issued or available to be issued (see Section 13.5.2.2 below), debt modifications that are made to avoid a covenant violation (see Section 13.5.2.3), and credit-related covenant violations that are cured before the financial statements are issued or available to be issued (see Section 13.5.2.4).

13.5.2.2 Covenant Violation After the Balance Sheet Date
The classification implications of credit-related debt covenant violations that occur after the balance sheet date but before the financial statements are issued or available to be issued are generally consistent with the requirements triggered by a violation as of the balance sheet date (see Section 13.5.1). A debt covenant violation that occurs after the balance sheet date but before the financial statements are issued or available to be issued would generally be an example of other “facts and circumstances,” as discussed in ASC 470-10-45-1 (see Section 13.5.3.3), under which current classification of the debt would be required unless one of the exceptions described in Section 13.5.3 applies. We have confirmed this position through informal discussions with the SEC staff.

Such scenarios primarily involve credit-related debt covenants, including those associated with quantitative financial metrics or ratios and those regarding going-concern matters. In some circumstances, the violation may be unrelated to credit or may be the result of a discrete event after year-end (e.g., a debt covenant that is triggered upon a sale of specified assets that occurred after year-end). We encourage entities to consult their advisers in these situations to determine the appropriate classification guidelines to apply.

Sometimes, a debtor might expect that it will violate a credit-related debt covenant only after the financial statements have been issued or are available to be issued. Unless the debtor is virtually certain that it will violate the covenant after such time, it should not classify the debt as a current liability on the basis of such anticipated covenant violation.

Example 13-3

Debt That Becomes Due on Demand as a Result of a Going-Concern Audit Opinion
Company ABC has a long-term loan that requires it to (1) comply with quantitative ratios, including liquidity ratios (e.g., current ratio, quick ratio) and financial leverage ratios (e.g., debt ratio, debt-to-equity ratio), and (2) obtain an audit opinion on its annual financial statements that is not subject to any qualifications or exceptions with respect to the scope of the audit or that contains a going-concern emphasis. If ABC does not comply with each of these covenant requirements, the lender has the ability to require repayment of the debt immediately. As of December 31, 20X1, ABC is in compliance with all of the quantitative ratios; however, the audit opinion issued for December 31, 20X1, will contain a going-concern emphasis. Company ABC does not obtain a waiver from the lender.

Because of the going-concern emphasis in the audit opinion, ABC should classify the loan as a current obligation in its December 31, 20X1, balance sheet. Although the audit opinion is issued after the balance sheet date, under ASC 470-10-45-1, such a known violation as of the date financial statements are issued or available to be issued would be considered an example of other “facts and circumstances” under which current classification of the debt would be required as of December 31, 20X1.
Example 13-4

Debt That Becomes Due on Demand Because of Failure to Satisfy Quantitative Covenants

Company ABC has a long-term loan that requires it to comply with quantitative ratios, including liquidity ratios (e.g., current ratio, quick ratio) and financial leverage ratios (e.g., debt ratio, debt-to-equity ratio). If ABC does not comply with each of these covenant requirements, the lender has the ability to require repayment of the debt immediately. Assume that ABC violated one of the quantitative ratio covenants as of a measurement date after the balance sheet date but before issuance of the financial statements. Assume also that ABC has obtained a waiver related to the specific violation before issuance of the financial statements for the year ended December 31, 20X1, and that ABC believes that it is probable that it will fail to meet the same covenant requirement again as of measurement dates occurring within the 12 months after December 31, 20X1.

In this situation, the covenant violation after the balance sheet date but before financial statement issuance should be viewed in the same way as a violation as of the balance sheet date (i.e., the violation constitutes evidence of “other facts and circumstances” as discussed in ASC 470-10-45-1). Since it is probable that ABC will not be able to comply with the same covenant as of compliance dates within 12 months of the balance sheet date, the debt should be classified as current as of December 31, 20X1.

13.5.2.3 Covenant Violation Would Have Occurred in the Absence of Debt Modification

ASC 470-10-55-4(d) and ASC 470-10-55-6 (see Section 13.5.3.3) indicate that a modification of the contractual terms of a debt obligation before the balance sheet date should be analyzed as a covenant violation as of the balance sheet date if all of the following conditions are met:

- The modification removes or adjusts the covenant so that the debtor will comply as of the balance sheet date.
- In the absence of the modification, the debtor would have violated the covenant as of the balance sheet date.
- The same or a more restrictive covenant must be met as of the compliance dates after the balance sheet date.

A debt modification that meets the above conditions is treated as a covenant waiver under ASC 470-10, even though no covenant violation exists as of the balance sheet date, because a covenant violation would have occurred notwithstanding the modification (i.e., in substance, the modification represents a waiver).

13.5.2.4 Covenant Violation Cured Before the Financial Statements Are Issued or Available to Be Issued

If a debtor cures a credit-related covenant violation before the financial statements are issued or available to be issued or before the creditor otherwise loses its right to demand repayment for more than one year (or the operating cycle, if longer) after the balance sheet date, the debt is classified as noncurrent (see ASC 470-10-45-11(a) and Section 13.5.3.2). For example, if a long-term debt obligation contains a put option that may be exercised by the creditor because of a covenant violation, but such option is only exercisable for 30 days after the balance sheet date, noncurrent classification is appropriate since the put option expired before the issuance of the financial statements.
13.5.3 Exceptions to the Current-Classification Requirements

13.5.3.1 Background
Violations of a covenant in a long-term obligation that makes the debt repayable on demand do not cause the debt to be classified as current if an exception in ASC 470-10 related to one or more of the following applies:

- Covenant waivers and cures (see Section 13.5.3.2 below).
- Grace periods (see Section 13.5.3.4).
- Refinancing arrangements (see Section 13.7).

13.5.3.2 Covenant Waivers and Cures

ASC 470-10

45-11 Current liabilities shall include long-term obligations that are or will be callable by the creditor either because the debtor's violation of a provision of the debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable. Accordingly, such callable obligations shall be classified as current liabilities unless either of the following conditions is met:

a. The creditor has waived or subsequently lost (for example, the debtor has cured the violation after the balance sheet date and the obligation is not callable at the time the financial statements are issued or are available to be issued [as discussed in Section 855-10-25]) the right to demand repayment for more than one year (or operating cycle, if longer) from the balance sheet date. If the obligation is callable because of violations of certain provisions of the debt agreement, the creditor needs to waive its right with regard only to those violations. . . .

Long-term obligations that become payable on demand or within one year (or the operating cycle, if longer) after the balance sheet date because of a covenant violation are classified as current liabilities unless the debtor obtains a covenant waiver that meets the requirements in ASC 470-10-45-1 and ASC 470-10-45-11(a) before the financial statements are issued or are available to be issued. Such debt would qualify as noncurrent if the creditor either waives its right to demand repayment under the specific covenant that was violated or otherwise loses its right to demand repayment (e.g., because the debtor cures the violation) for a period of more than one year after the balance sheet date. However, noncurrent classification would not be permitted if the creditor retains its right to demand repayment with respect to future covenant violations and it is probable that the debtor will violate the same or a more restrictive covenant as of measurement dates that are within 12 months of the balance sheet date (see Section 13.5.3.3).

Debt cannot be classified as noncurrent unless a waiver is binding and eliminates the creditor's right to demand repayment of the debt within one year (or the operating cycle, if longer) after the balance sheet date as a result of the covenant violation. If the creditor has a right to revoke the waiver at its sole discretion, the waiver would not meet this condition. Further, a creditor's statement that it does not intend or expect to demand repayment in the event of a covenant violation does not represent a waiver. A debtor is not permitted to consider the likelihood that a creditor will grant a waiver in the future even if the creditor has historically issued a waiver for the same type of violation or other covenant violations.
Lenders often request something in exchange for a covenant waiver. For example, the parties might agree to an up-front fee, an increase to the interest rate, a principal modification, the addition of a cross-default provision, or additional collateral. Since such changes represent modifications to the contractual terms of the original debt instrument, the debtor should consider whether the modifications are TDRs under ASC 470-60 (see Chapter 11) and, if not, whether to account for them as an extinguishment or modification of the original debt under ASC 470-50 (see Chapter 10). Unless it performs the necessary calculations, an entity cannot assume that the payment of a fee to obtain a debt covenant waiver does not pass the 10 percent cash flow test under ASC 470-50 (see Section 10.3.3).

### 13.5.3.3 Recurring Covenant Tests

**ASC 470-10**

45-1 Some long-term loans require compliance with certain covenants that must be met on a quarterly or semiannual basis. If a covenant violation occurs that would otherwise give the lender the right to call the debt, a lender may waive its call right arising from the current violation for a period greater than one year while retaining future covenant requirements. Unless facts and circumstances indicate otherwise, the borrower shall classify the obligation as noncurrent, unless both of the following conditions exist:

a. A covenant violation that gives the lender the right to call the debt has occurred at the balance sheet date or would have occurred absent a loan modification.

b. It is probable that the borrower will not be able to cure the default (comply with the covenant) at measurement dates that are within the next 12 months.

See Example 1 (paragraph 470-10-55-2) for an illustration of this classification guidance.

The contractual terms of long-term debt obligations often contain covenants that must be met on certain dates and that render the debt repayable on demand if they are not met on those dates. If such a covenant has been violated as of the balance sheet date or before the date on which the financial statements are issued or available to be issued, the debt must be classified as current unless one of the exceptions in ASC 470-10-45-11 or ASC 470-10-45-14 applies (see Section 13.5.3.1).

ASC 470-10-45-1 addresses the application of ASC 470-10-45-11 to covenant waivers (see Section 13.5.3.2) in situations in which the creditor has waived the specific covenant that was violated as of the balance sheet date but retains its right to demand debt repayment if the debtor violates the same or a more restrictive covenant on subsequent compliance dates within one year (or the operating cycle, if longer) after the balance sheet date. This guidance applies when a debtor would have violated a covenant as of the balance sheet date in the absence of a modification to the debt terms (i.e., a debt modification before the balance sheet date is treated as a waiver of a debt covenant under this guidance; see Section 13.5.2.3).

**Example 13-5**

**Recurring Minimum Working Capital Requirement**

The terms of a debt obligation require the debtor to maintain a minimum amount of working capital in each fiscal quarter. If the working capital requirement is not met, the creditor obtains the right to immediately accelerate the due date of the debt's outstanding amount. The debtor violates the covenant as of December 31, 20X1. Further, the creditor waives its right to accelerate the due date of the debt as a result of the debtor's violation of the covenant as of December 31, 20X1. However, the debtor retains its right to accelerate the debt's due date if the covenant is not met as of March 31, 20X2. In this scenario, the debtor must consider the guidance in ASC 470-10-45-1.
Generally, a long-term obligation should be classified as noncurrent if the creditor has waived the specific covenant violation unless it is probable that the debtor will be unable to cure the violation on the compliance dates within the next 12 months (or the operating cycle, if longer) after the balance sheet date. If it is reasonably possible that the debtor will meet the same and more restrictive covenants on the subsequent compliance dates within the next 12 months (or the operating cycle, if longer) after the balance sheet date, the debt should be classified as noncurrent. However, the obligation should be classified as current if it is probable that debtor will be unable to meet the covenant on any of the subsequent compliance dates within the next 12 months (or the operating cycle, if longer) after the balance sheet date. In other words, the obligation should be classified as current if there is a remote likelihood that the debtor will meet the covenant on all subsequent compliance dates within the next 12 months (or the operating cycle, if longer) after the balance sheet date.

Note that the guidance on recurring covenant tests includes a different likelihood threshold for curing the covenant violation than the guidance on grace periods. For a debtor to justify noncurrent classification under the guidance on grace periods, curing the default must be probable (see Section 13.5.3.4), whereas it must merely not be probable that the debtor will be unable to cure the default under the guidance on recurring covenant tests.

**ASC 470-10**

*Example 1: Classification of Long-Term Debt That Includes Covenants*

55-2 This Example illustrates the guidance in paragraph 470-10-45-1 for the classification of long-term debt when a debt covenant violation is waived by a lender for a period greater than a year.

55-3 A borrower has a long-term loan that requires compliance with certain covenants, such as maintenance of a minimum current ratio, minimum debt-to-equity ratio, or minimum level of shareholders’ equity. The borrower must meet the covenants on a quarterly or semiannual basis. At one of the compliance dates, the borrower violates a covenant. That violation gives the lender the right to call the debt. The lender waives that right for a period greater than one year but retains the future covenant requirements.

55-4 The issue is whether the waiver of the lender’s rights resulting from the violation of the covenant with the retention of the periodic covenant tests represents, in substance, a grace period. If viewed as a grace period, the borrower would classify the debt as current (see paragraph 470-10-45-11) unless it is probable that the borrower can cure the violation (comply with the covenant) within the grace period. Specifically, the balance sheet classification of an obligation is considered in the following situations:

a. The debt covenants are applicable only after the balance sheet date, and it is probable that the borrower will fail to meet the covenant requirement at the compliance date three months after the balance sheet date.

b. The borrower meets the current covenant requirement at the balance sheet date, and it is probable that the borrower will fail to meet the same covenant requirement at the compliance date in three months.

c. The borrower meets the current covenant requirement, and it is probable that the borrower will fail to meet a more restrictive covenant requirement applicable at the compliance date in three months.

d. The borrower has met the covenant requirement in the prior quarter but before the balance sheet date negotiates a modification of the loan agreement that eliminates the covenant requirement at the balance sheet date or modifies the requirement so that the borrower will comply. Absent the modification, the borrower would have been in violation of the covenant at the balance sheet date. The same or a more restrictive covenant must be met at the compliance date in three months, and it is probable that the borrower will fail to meet that requirement at that subsequent date.

e. The borrower is in violation of the current covenant requirement at the balance sheet date and, after the balance sheet date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), obtains a waiver. The same or a more restrictive covenant must be met at the compliance date in three months, and it is probable that the borrower will fail to meet that requirement at that subsequent date.
55-5 In the situations described in (a) through (c) of the preceding paragraph, the debt would be classified as noncurrent, in which case the borrower would be required to disclose the adverse consequences of its probable failure to satisfy future covenants.

55-6 In the situations described in paragraph 470-10-55-4(d) through (e), the debt would be classified as current. However, if the debt is expected to be refinanced on a long-term basis and the borrower meets the provisions of paragraphs 470-10-45-13 through 45-20, the debt would be classified as noncurrent.

### 13.5.3.4 Grace Periods

**ASC 470-10**

45-11 Current liabilities shall include long-term obligations that are or will be callable by the creditor either because the debtor’s violation of a provision of the debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable. Accordingly, such callable obligations shall be classified as current liabilities unless either of the following conditions is met: . . .

- **b.** For long-term obligations containing a grace period within which the debtor may cure the violation, it is probable that the violation will be cured within that period, thus preventing the obligation from becoming callable.

Generally, long-term debt that has become payable on demand or within one year (or the operating cycle, if longer) after the balance sheet date because of a covenant violation is classified as current (see Section 13.5.1). However, if the debt agreement contains a grace period during which the debtor may cure the violation, the debtor classifies the debt as noncurrent if it is probable that the violation will be cured within the established grace period.

In determining whether it is probable that the violation will be cured within the contractual grace period, a debtor must use judgment and consider all relevant facts and circumstances. In the absence of persuasive evidence that it is probable that the debtor will be able to cure the violation before the end of the grace period, the obligation should be classified as current unless the debtor has obtained a covenant waiver that meets the requirements in ASC 470-10-45-11(a) (see Section 13.5.3.2) or the debtor has the intent and ability to refinance the obligation on a long-term basis (see Section 13.7). If a more than remote likelihood exists that the debtor will be unable to remedy the violation, the debt should be classified as current even if the debtor expects that the creditor will not demand repayment.

ASC 470-10-50-2 requires a debtor to disclose the circumstances in which it is in violation of a debt covenant but classifies the related debt as noncurrent because it is probable that the violation will be cured within a specified grace period (see Section 13.5.4).

### 13.5.3.5 Comparison of Guidance on Covenant Waivers and Grace Periods

When a lender issues a covenant waiver, the related debt is classified as noncurrent unless it is probable that the debtor will violate the same or a more restrictive covenant again as of a measurement date that is within 12 months of the balance sheet date (see Section 13.5.3.3). By contrast, when a loan agreement contains a grace period, the related debt is classified as current unless it is probable that the debtor will cure the violation within the specified grace period, thus preventing the obligation from becoming repayable on demand (see Section 13.5.3.4). The decision tree below summarizes the guidance on classification of debt upon the violation of a covenant as of the balance sheet date.
Chapter 13 — Balance Sheet Classification

Example 13-6
Failure to Satisfy Debt Covenant — No Grace Period Provided in Debt Agreement

Company A has a long-term loan that requires it to comply with certain covenants, including quarterly minimum quantitative ratios (e.g., a debt-to-equity ratio) and issuance of annual audited financial statements with an audit opinion that is not subject to any qualifications or exceptions with respect to the scope of the audit or any going-concern emphasis. Company A failed to meet the minimum quantitative ratio as of December 31, 20X1. Thus, the lender has the right to demand repayment of the debt immediately. The loan agreement does not specify a grace period for curing covenant violations.

Company A must classify the debt as current as of December 31, 20X1. When a loan agreement does not contain a grace period, long-term debt should be classified as current when a debtor is in violation of a loan covenant as of the balance sheet date since the obligation is repayable on demand by the lender.

Example 13-7
Failure to Satisfy Debt Covenant — Grace Period Provided in Debt Agreement

Assume the same facts as in Example 13-6 above, except that the loan agreement contains a grace period during which the debtor can cure the violation. Company A would need to assess the probability of curing the covenant violation. Unless A determines that it is probable that the covenant violation will be cured within the specified grace period, current classification of the loan would be required.

Example 13-8
Failure to Satisfy Debt Covenant — Waiver Obtained by Debtor

Assume the same facts as in Example 13-6 except that the lender has waived its right to demand repayment of the loan related to the specific covenant violation for a period of more than 12 months after the balance sheet date. Company A would classify the debt as a current liability only if it is probable that it will violate the same or a more restrictive covenant again as of measurement dates that are within 12 months of the balance sheet date (see Section 13.5.3.3).
### 13.5.4 Disclosure

<table>
<thead>
<tr>
<th>ASC 470-10</th>
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<tbody>
<tr>
<td>50-2 If an obligation under paragraph 470-10-45-11(b) is classified as a long-term liability (or, in the case of an unclassified balance sheet, is included as a long-term liability in the disclosure of debt maturities), the circumstances shall be disclosed.</td>
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<table>
<thead>
<tr>
<th>SEC Regulation S-X, Rule 4-08</th>
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<tbody>
<tr>
<td>§210.4-08 General Notes to Financial Statements [Reproduced in ASC 235-10-S99-1]</td>
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<tr>
<td>If applicable to the person for which the financial statements are filed, the following shall be set forth on the face of the appropriate statement or in appropriately captioned notes. The information [required by paragraph (c)] shall be provided as of the most recent audited balance sheet being filed . . . . When specific statements are presented separately, the pertinent notes shall accompany such statements unless cross-referencing is appropriate. . . .</td>
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<tr>
<td>(c) Defaults. The facts and amounts concerning any default in principal, interest, sinking fund, or redemption provisions with respect to any issue of securities or credit agreements, or any breach of covenant of a related indenture or agreement, which default or breach existed at the date of the most recent balance sheet being filed and which has not been subsequently cured, shall be stated in the notes to the financial statements. If a default or breach exists but acceleration of the obligation has been waived for a stated period of time beyond the date of the most recent balance sheet being filed, state the amount of the obligation and the period of the waiver . . . .</td>
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<table>
<thead>
<tr>
<th>Nonauthoritative AICPA Guidance</th>
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<tbody>
<tr>
<td>Technical Q&amp;As Section 3200, “Long-Term Debt”</td>
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<td>.17 Disclosure of Covenant Violation and Subsequent Bank Waiver</td>
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<tr>
<td>Inquiry — At the balance-sheet date, an entity was in violation of certain provisions of the loan covenant associated with its long-term debt. Under the terms of the loan agreement, the obligation is now callable by the creditor. Subsequent to the balance-sheet date, the bank waived its right to demand repayment for more than one year from the balance-sheet date. Therefore, the loan remained classified as long-term, per Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 470-10-45-12. Does the covenant violation and subsequent bank waiver need to be disclosed in the financial statements?</td>
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<td>Reply — The authoritative literature applicable to nonpublic entities does not address disclosure of debt covenant violations existing at the balance-sheet date that have been waived by the creditor for a stated period of time. Nevertheless, disclosure of the existing violation(s) and the waiver period should be considered for reasons of adequate disclosure. If the covenant violation resulted from nonpayment of principal or interest on the debt, inability to maintain required financial ratios, or other such financial covenants, that information may be vital to users of the financial statements even though the debt is not callable. If the lender has waived the right for greater than one year but retained the future covenant requirements (i.e., covenant requirements will have to be met at interim dates during the next 12 months), the accounting and disclosure provisions of FASB ASC 470, Debt, apply.</td>
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<td>For SEC registrants, Regulations S-X, Article 4, Section 210-4-08(c), requires disclosure of the amount of the obligation and the period of waiver whenever a creditor has waived its right to call the debt for a stated period of time . . .</td>
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</table>
ASC 470-10-50-2 requires a debtor to disclose the circumstances in which it is in violation of a debt covenant but classifies the related debt as noncurrent because it is probable that the violation will be cured with a specified grace period that extends beyond the date on which the financial statements are to be issued (see Section 13.5.3.4). For example, it might be appropriate to disclose a description of the nature of the violation, the actions taken by the debtor to cure the violation, and a statement that it is probable that the violation will be cured before the end of the grace period. In addition, debtors that do not present a classified balance sheet and describe the obligation as a long-term liability must disclose this description in their discussion of debt maturities.

Further, SEC Regulation S-X, Rule 4-08, requires SEC registrants to disclose information about (1) the facts and amounts associated with any defaults or other covenant violations that existed as of the balance sheet date and that have not been subsequently cured and (2) the amount and the period of the waiver if a waiver of a default or covenant violation was given for a period beyond the balance sheet date. As discussed in AICPA Technical Q&As Section 3200.17, disclosure of covenant waivers and the waiver period “may be vital” also for users of financial statements of nonpublic entities.

### 13.6 SACs in Long-Term Obligations

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<th><strong>ASC 470-10</strong></th>
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<tr>
<td><strong>45-2</strong> In some situations, the circumstances (for example, recurring losses or liquidity problems) would indicate that long-term debt subject to a subjective acceleration clause should be classified as a current liability. Other situations would indicate only disclosure of the existence of such clauses. Neither reclassification nor disclosure would be required if the likelihood of the acceleration of the due date were remote, such as if the lender historically has not accelerated due dates of loans containing similar clauses and the financial condition of the borrower is strong and its prospects are bright.</td>
</tr>
<tr>
<td><strong>50-3</strong> As indicated in paragraph 470-10-45-2, in some situations long-term debt subject to a subjective acceleration clause shall be reclassified. That paragraph explains that other situations would indicate only disclosure of the existence of such clauses. That paragraph states further that neither reclassification nor disclosure is required if the likelihood of the acceleration of the due date is remote, such as when the lender historically has not accelerated due dates of loans containing similar clauses and the financial condition of the borrower is strong and its prospects are bright.</td>
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If a long-term debt obligation contains a SAC, the debtor should assess the likelihood that the creditor will accelerate the debt's due date. If exercise of the SAC is probable, the long-term obligation must be classified as a current liability and the SAC disclosed. If the debtor has experienced recurring losses or liquidity problems, the obligation should be classified as current unless the exception for refinancing arrangements applies (see Section 13.7). If the likelihood that the creditor will accelerate the debt's due date is reasonably possible, the existence of the SAC should be disclosed. If the likelihood that the debt's due date will be accelerated is remote, neither disclosure nor reclassification is required. If a creditor has accelerated the debt's due date under a SAC, the debt is considered due on demand (see Section 13.4) and is classified as current unless the exception for refinancing arrangement is met.

ASC 470-10 contains guidance on the impact of SACs on the classification of revolving-debt arrangements that require a lockbox arrangement (see Section 13.8).
13.7 Refinancing Arrangements

13.7.1 Background
Under ASC 470-10-45-14, short-term obligations are classified as noncurrent if the debtor has the intent and ability to refinance the obligation on a long-term basis. To demonstrate that it has such an intent and ability, a debtor must (1) refinance the obligation on a long-term basis (see Section 13.7.3) after the balance sheet date, but before the financial statements are issued or available to be issued, or (2) have a financing agreement that clearly permits it to refinance the obligation on a long-term basis (see Section 13.7.4) before the financial statements are issued or available to be issued.

13.7.2 Scope

13.7.2.1 Background
ASC 470-10-45-14 applies to certain short-term obligations (see Section 13.3.4.2) of a debtor that has the intent and ability to refinance on a long-term basis (see Section 13.7.2.2 below). It does not apply to certain short-term obligations incurred as part of an entity’s operating cycle (see Section 13.7.2.3). Further, the post-balance-sheet-date refinancing or financing agreement must be in place before the financial statements are issued or available to be issued (see Section 13.3.4.9).

13.7.2.2 Refinancing a Short-Term Obligation on a Long-Term Basis

<table>
<thead>
<tr>
<th>ASC 470-10</th>
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<tbody>
<tr>
<td>45-12A Some short-term obligations are expected to be refinanced on a long-term basis and, therefore, are not expected to require the use of working capital during the ensuing fiscal year. Examples include commercial paper, construction loans, and the currently maturing portion of long-term debt.</td>
</tr>
<tr>
<td>45-12B Refinancing a short-term obligation on a long-term basis means either replacing it with a long-term obligation or with equity securities or renewing, extending, or replacing it with short-term obligations for an uninterrupted period extending beyond one year (or the operating cycle, if applicable) from the date of an entity's balance sheet.</td>
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<tr>
<td>45-13 ... A short-term obligation shall be excluded from current liabilities only if the conditions in the following paragraph are met. Funds obtained on a long-term basis before the balance sheet date would be excluded from current assets if the obligation to be liquidated is excluded from current liabilities.</td>
</tr>
<tr>
<td>45-14 A short-term obligation shall be excluded from current liabilities if the entity intends to refinance the obligation on a long-term basis (see paragraph 470-10-45-12B) and the intent to refinance the short-term obligation on a long-term basis is supported by an ability to consummate the refinancing demonstrated in either of the following ways:</td>
</tr>
<tr>
<td>a. Post-balance-sheet-date issuance of a long-term obligation or equity securities. ...</td>
</tr>
<tr>
<td>b. Financing agreement. ...</td>
</tr>
<tr>
<td>45-21 Replacement of a short-term obligation with another short-term obligation after the date of the balance sheet but before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25) is not, by itself, sufficient to demonstrate an entity’s ability to refinance the short-term obligation on a long-term basis. If, for example, the replacement is made under the terms of a revolving credit agreement that provides for renewal or extension of the short-term obligation for an uninterrupted period extending beyond one year (or operating cycle) from the date of the balance sheet, the revolving credit agreement must meet the conditions in paragraph 470-10-45-14(b) to justify excluding the short-term obligation from current liabilities. Similarly, if the replacement is a rollover of commercial paper accompanied by a standby credit agreement, the standby agreement must meet the conditions in that paragraph to justify excluding the short-term obligation from current liabilities.</td>
</tr>
</tbody>
</table>
As discussed in Section 13.7.1, ASC 470-10-45-14 applies when a debtor has the intent and ability to refinance a short-term obligation on a long-term basis. ASC 470-10-45-12B clarifies that refinancing a short-term obligation on a long-term basis includes:

- Issuing a long-term obligation that replaces the short-term obligation.
- Issuing equity securities that replace the short-term obligation.
- Renewing or extending a short-term obligation for a period of more than one year (or the operating cycle, if longer) after the balance sheet date. (Note that provisions that permit the successive renewal or extension of short-term obligations generally should be evaluated under the guidance on financing agreements [see Section 13.7.4] and not under the requirements for post-balance-sheet-date issuance of long-term obligations or equity securities [see Section 13.7.3] since they do not represent long-term obligations.)

A debtor does not have the intent and ability to refinance a short-term obligation on a long-term basis if:

- It issues another short-term obligation that matures within one year (or the operating cycle, if longer) after the balance sheet date.
- It extends or renews a short-term obligation for a period of less than one year (or the operating cycle, if longer) after the balance sheet date.
- The short-term financing agreement expires within one year (or the operating cycle, if longer) after the balance sheet date.

### 13.7.2.3 Short-Term Obligations Related to the Operating Cycle

ASC 470-10 does not apply to short-term obligations that are classified as current liabilities under ASC 210-10-45-8 and the first sentence of ASC 470-10-45-13 (see Section 13.3.3.4). That is, “[S]hort-term obligations arising from transactions in the normal course of business that are due in customary terms,” such as payables for goods and services and accruals for wages, salaries, commissions, rentals, and royalties, cannot be classified as noncurrent on the basis of the guidance on refinancing arrangements. However, as noted in paragraph 20 of the Basis for Conclusions of FASB Statement 6, the guidance does apply to short-term obligations “arising from the acquisition or construction of noncurrent assets” or “not directly related to the operating cycle,” such as a “note given to a supplier to replace an account payable that originally arose in the normal course of business and had been due in customary terms.”
13.7.3 Post-Balance-Sheet-Date Issuance of Long-Term Debt or Equity

13.7.3.1 General

ASC 470-10

45-14 A short-term obligation shall be excluded from current liabilities if the entity intends to refinance the obligation on a long-term basis (see paragraph 470-10-45-12B) and the intent to refinance the short-term obligation on a long-term basis is supported by an ability to consummate the refinancing demonstrated in either of the following ways:

a. Post-balance-sheet-date issuance of a long-term obligation or equity securities. After the date of an entity's balance sheet but before that balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), a long-term obligation or equity securities have been issued for the purpose of refinancing the short-term obligation on a long-term basis. If equity securities have been issued, the short-term obligation, although excluded from current liabilities, shall not be included in owners' equity. . . .

45-16 If an entity's ability to consummate an intended refinancing of a short-term obligation on a long-term basis is demonstrated by post-balance-sheet-date issuance of a long-term obligation or equity securities (see paragraph 470-10-45-14(a)), the amount of the short-term obligation to be excluded from current liabilities shall not exceed the proceeds of the new long-term obligation or the equity securities issued.

One way a debtor can demonstrate its intent and ability to refinance a short-term obligation on a long-term basis is to repay the short-term obligation by using the proceeds from the issuance of a long-term obligation or equity securities. Such refinancing must occur before the financial statements are issued or available to be issued (see Section 13.3.4.9). The amount of the short-term obligation that is classified as noncurrent cannot exceed the amount of the proceeds received from issuing the new long-term obligation or equity securities and that are used to repay the short-term obligation.

The issuance of a new debt instrument or equity security that contains a put option or other provision that permits the holder to demand repayment within one year (or the operating cycle, if longer) after the balance sheet date does not demonstrate the debtor's ability to refinance on a long-term basis (see Section 13.4.2). A debtor that has violated a credit-related covenant in the new debt obligation before the financial statements are issued or available to be issued should consider the guidance on covenant violations (see Section 13.5). If a new long-term debt obligation contains a SAC, the debtor should assess the likelihood that the holder will accelerate the debt's due date under that clause since it can affect whether noncurrent classification is appropriate (see Section 13.6).

ASC 470-10-55-15 through 55-24 contain an example of a post-balance-sheet-date refinancing that would be evaluated under ASC 470-10-45-14(a) (see Section 13.7.6.3).

13.7.3.2 Repayment of Short-Term Obligation Before Long-Term Refinancing

ASC 470-10

45-15 Repayment of a short-term obligation before funds are obtained through a long-term refinancing requires the use of current assets. Therefore, if a short-term obligation is repaid after the balance sheet date and subsequently a long-term obligation or equity securities are issued whose proceeds are used to replenish current assets before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), the short-term obligation shall not be excluded from current liabilities at the balance sheet date. See Example 5 (paragraph 470-10-55-33) for an illustration of this guidance.
If a debtor repays a short-term obligation after the balance sheet date by using current assets (e.g., excess cash), that obligation must be classified as current as of the balance sheet date even if the debtor subsequently issues a new long-term obligation or equity securities before the financial statements are issued or available to be issued. This is because the repayment of the short-term obligation required the use of current assets. ASC 470-10-55-33 through 55-36 contain an example of a short-term obligation that is repaid after the balance sheet date and subsequently replaced by long-term debt before the balance sheet is issued (see Section 13.7.6.3).

13.7.4 Financing Agreement

13.7.4.1 Background

A debtor can demonstrate that it is able to refinance a short-term obligation on a long-term basis by having a financing agreement (e.g., a term loan commitment, a line of credit, a revolving-debt arrangement, an equity facility, or a forward sale of debt or equity securities) that permits such refinancing and meets certain criteria (see Section 13.7.4.2 below). Further, the guidance on financing agreements applies to scenarios in which the debtor renews or extends the short-term obligation (see ASC 470-10-45-12B).

ASC 470-10 limits the amount of the short-term obligation that can be classified as noncurrent (see Section 13.7.4.3). Generally, a debtor is not precluded from using a stand-by financing agreement, although its terms cannot be unreasonable (see Section 13.7.4.4). However, a best-efforts agreement cannot be used to demonstrate an ability to refinance a short-term obligation on a long-term basis (see Section 13.7.4.5). In certain circumstances, a subsidiary might be able to use a parent’s financing agreement to demonstrate such ability (see Section 13.7.4.6).

13.7.4.2 Financing Agreement Criteria

<table>
<thead>
<tr>
<th>ASC 470-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-14 A short-term obligation shall be excluded from current liabilities if the entity intends to refinance the obligation on a long-term basis (see paragraph 470-10-45-12B) and the intent to refinance the short-term obligation on a long-term basis is supported by an ability to consummate the refinancing demonstrated in either of the following ways: . . .</td>
</tr>
<tr>
<td>b. Financing agreement. Before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), the entity has entered into a financing agreement that clearly permits the entity to refinance the short-term obligation on a long-term basis on terms that are readily determinable, and all of the following conditions are met:</td>
</tr>
<tr>
<td>1. The agreement does not expire within one year (or operating cycle) from the date of the entity’s balance sheet and during that period the agreement is not cancelable by the lender or the prospective lender or investor (and obligations incurred under the agreement are not callable during that period) except for violation of a provision with which compliance is objectively determinable or measurable. For purposes of this Subtopic, violation of a provision means failure to meet a condition set forth in the agreement or breach or violation of a provision such as a restrictive covenant, representation, or warranty, whether or not a grace period is allowed or the lender is required to give notice. Financing agreements cancelable for violation of a provision that can be evaluated differently by the parties to the agreement (such as a material adverse change or failure to maintain satisfactory operations) do not comply with this condition.</td>
</tr>
<tr>
<td>2. No violation of any provision in the financing agreement exists at the balance sheet date and no available information indicates that a violation has occurred thereafter but before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), or, if one exists at the balance sheet date or has occurred thereafter, a waiver has been obtained.</td>
</tr>
<tr>
<td>3. The lender or the prospective lender or investor with which the entity has entered into the financing agreement is expected to be financially capable of honoring the agreement.</td>
</tr>
</tbody>
</table>
### ASC 470-10 (continued)

**55-1** Under paragraph 470-10-45-2, the lender has already loaned money on a long-term basis. To continue long-term classification requires a judgment about the likelihood of acceleration of the due date. Paragraphs 470-10-45-13 through 45-20 cover circumstances in which the obligation is by its terms short-term. For such an obligation to be excluded from current liabilities, the lender must advance new funds or refinance the short-term obligation on a long-term basis based on conditions existing on the date of the new loan or refinancing. Therefore, to classify an obligation as long-term, paragraphs 470-10-45-13 through 45-20 require a higher standard for a financing agreement that permits an entity to refinance a short-term obligation on a long-term basis than paragraph 470-10-50-2 requires for an existing long-term loan for which early repayment might be requested.

For debt to be classified as noncurrent on the basis of a financing agreement, all of the following conditions must be met:

1. **The financing agreement must clearly permit the debtor to refinance the short-term obligation on a long-term basis on terms that are readily determinable.**

   The terms of the financing commitment must be unambiguous about whether the debtor is able to refinance the short-term obligation on a long-term basis. For example, the agreement might state that “[b]orrowings are available at [the debtor’s] request for such purposes as it deems appropriate and will mature three years from the date of borrowing” (see ASC 470-10-55-16(b) and ASC 470-10-55-17 in Section 13.7.6.4). Further, the debtor cannot be subject to any legal or contractual restrictions that prevent it from accessing funds that otherwise would be available under the financing agreement (e.g., transfer restrictions) (see Section 13.7.4.3). If the amount available under the financing agreement fluctuates, only the minimum amount that is expected to be available can be used to support a conclusion that noncurrent classification is appropriate for a short-term obligation. If the amount available under the financing agreement fluctuates and no reasonable estimate of the minimum amount that is expected to be available can be made, the financing agreement does not allow the debtor to refinance a short-term obligation on a long-term basis (see Section 13.7.4.3).

   In addition, the agreement must bind the potential creditor or investor to extend credit on a long-term basis or purchase the debtor’s equity securities. If the potential creditor or investor has a right to cancel the agreement in its sole discretion without any penalty or damages, the agreement would not meet this condition. For example, a letter of intent or memorandum of understanding would generally not be sufficient to meet this condition even if the potential investor or creditor is expected to honor its stated intent. Further, ASC 470-10-55-8 implies that the existence of a best-efforts remarketing agreement is not sufficient to demonstrate an intent and ability to refinance a short-term obligation on a long-term basis under ASC 470-10-45-14(b) (see Section 13.7.4.5). However, there is no requirement that the financing agreement be contractually linked to the short-term obligation.

   The fact that a debtor is considering other more advantageous sources of financing does not necessarily preclude it from asserting an intent to use a financing agreement to refinance a short-term obligation on a long-term basis under ASC 470-10-45-14(b) (see Section 13.7.4.4). However, the debtor must intend to use the financing agreement if no other source of financing becomes available (see ASC 470-10-45-20).
2. **The financing agreement must be in place as of the date the financial statements are issued or available to be issued.**

   There is no requirement that the debtor enter into the financing agreement as of the balance sheet date. ASC 470-10-45-14(b) requires the financing agreement to have been executed by the time the financial statements are issued or available to be issued.

3. **The financing agreement cannot expire within one year (or the debtor's operating cycle, if longer) after the balance sheet date except for the violation of an objective covenant.**

   ASC 470-10-45-14(b)(1) requires the potential creditor's or investor's commitment under the financing agreement to be for at least one year (or the operating cycle, if longer) after the balance sheet date. During that period, the potential creditor or investor cannot have a right to cancel the agreement unless the debtor violates a provision (e.g., a restrictive covenant, representation, or warranty) with which compliance is objectively determinable or measurable (see item 5 below and Section 13.3.4.6).

4. **The obligations or equity securities that would be issued under the financing agreement cannot be repayable on demand or within one year (or the operating cycle, if longer) after the balance sheet date.**

   ASC 470-10-45-14(b)(1) indicates that any obligation incurred or equity securities issued under the financing agreement cannot be repayable on demand or within one year (or the debtor's operating cycle, if longer) after the balance sheet date. Obligations that are repayable on demand or within one year (or the debtor's operating cycle, if longer) after the balance sheet date are considered short-term obligations (see Section 13.4). Similarly, the renewal or extension of a short-term obligation for a period of more than one year would not meet this condition if the obligation contains a put option or other provision that permits the holder to demand repayment within one year after the balance sheet date.

5. **The financing agreement and any obligations that would be issued under the financing agreement cannot contain a SAC.**

   ASC 470-10-45-14(b)(1) indicates that the financing agreement cannot contain a SAC (see Section 13.3.4.6). For example, a liquidity facility with a material adverse change clause that permits the potential creditor or investor to terminate the facility would not qualify under this condition.

Note that a long-term financing arrangement might not meet the conditions in ASC 470-10-45-14(b) for classification of a short-term obligation as noncurrent even if the debt that would be issued under the financing agreement would qualify as noncurrent once issued (see ASC 470-10-55-1). Long-term obligations with SACS often qualify as noncurrent under ASC 470-10-45-2 (see Section 13.6). However, a financing agreement can only be used as the basis for excluding a short-term obligation from current liabilities if the financing cannot be cancelled by the lender on the basis of a SAC. The FASB believes that the circumstances addressed in the guidance on refinancing agreements in ASC 470-10-45-13 through 45-20 are different from those addressed in the guidance on SACS in long-term obligations in ASC 470-10-45-2. That is, the guidance on SACS in long-term obligations requires an entity to use judgment in determining the likelihood of acceleration of the due date of the long-term obligation, whereas the guidance on refinancing arrangements in ASC 470-10-45-14 requires the creditor to advance new funds or refinance the short-term obligation on a long-term basis.
6. **If the debtor has violated a provision in the financing agreement, it has obtained a waiver.**

Under ASC 470-10-45-14(b)(2), the debtor must not be in violation of any provision in the financing agreement on the balance sheet date or when the financial statements are issued or available to be issued or, if a violation has occurred, the other party must have granted a waiver. Waivers should be evaluated under the guidance in ASC 470-10 on waivers (see Sections 13.5.3.2 and 13.5.3.3).

7. **The potential creditor or investor must be expected to be financially capable of honoring the agreement.**

Under ASC 470-10-45-14(b)(3), the potential creditor or investor must be “expected to be financially capable of honoring the [financing] agreement.” If substantial doubt exists about the potential creditor’s or investor’s capacity to honor its commitment, this condition is not met.

8. **The terms of the financing agreement cannot be unreasonable to the debtor.**

If the terms of a financing agreement are unreasonable to the debtor (e.g., with respect to interest rates or collateral requirements), the debtor would not be able to assert an intent to refinance the short-term obligation on a long-term basis under that agreement. Although a debtor is permitted to seek alternative sources of financing (see Section 13.7.4.4), it must intend to use the existing financing agreement if another source of financing does not become available.

### 13.7.4.3 Limit on the Amount That Can Be Classified as Noncurrent

<table>
<thead>
<tr>
<th>ASC 470-10</th>
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<tbody>
<tr>
<td><strong>45-17</strong> If ability to refinance is demonstrated by the existence of a financing agreement (see paragraph 470-10-45-14(b)), the amount of the short-term obligation to be excluded from current liabilities shall be reduced to the amount available for refinancing under the agreement if the amount available is less than the amount of the short-term obligation.</td>
</tr>
<tr>
<td><strong>45-18</strong> The amount to be excluded shall be reduced further if information (such as restrictions in other agreements or restrictions as to transferability of funds) indicates that funds obtainable under the agreement will not be available to liquidate the short-term obligation.</td>
</tr>
<tr>
<td><strong>45-19</strong> Further, if amounts that could be obtained under the financing agreement fluctuate (for example, in relation to the entity's needs, in proportion to the value of collateral, or in accordance with other terms of the agreement), the amount to be excluded from current liabilities shall be limited to a reasonable estimate of the minimum amount expected to be available at any date from the scheduled maturity of the short-term obligation to the end of the fiscal year (or operating cycle). If no reasonable estimate can be made, the entire outstanding short-term obligation shall be included in current liabilities.</td>
</tr>
</tbody>
</table>

The amount of a short-term obligation that can be classified as noncurrent cannot exceed the amount that the debtor is able to access under the financing agreement and should take into account any limitations on the debtor's ability to access the amount committed under the financing agreement. For example, the debtor may be subject to legal or contractual restrictions that prevent it from using some or all of the amount committed under the financing agreement to repay its short-term obligation. ASC 470-10-55-20 and 55-21 (see Section 13.7.6.4) include an example of a scenario in which the transfer of funds between a parent and subsidiary is legally restricted so that the parent is unable to access funds that are available under the subsidiary's financing agreement.
If the amount obtainable under a financing agreement fluctuates (e.g., on the basis of collateral value of the debtor's trade receivables), the debtor should make a reasonable estimate of the minimum amount expected to be available on any date during the period from the scheduled maturity of the short-term obligation to the end of the fiscal year (or the entity's operating cycle, if longer). If a reasonable estimate cannot be made, the financing agreement cannot be used to support a decision to exclude the short-term obligation from current liabilities. ASC 470-10-55-27 through 55-29 (see Section 13.7.6.4) contain an example of a financing agreement that meets the conditions in ASC 470-10-45-14(b) and limits the amount that the debtor can borrow under the agreement to the amount of its inventory.

13.7.4.4 Standby Financing Agreement

<table>
<thead>
<tr>
<th>ASC 470-10</th>
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<tbody>
<tr>
<td>45-20 The entity may intend to seek an alternative source of financing rather than to exercise its rights under the existing agreement when the short-term obligation becomes due. The entity must intend to exercise its rights under the existing agreement, however, if that other source does not become available. The intent to exercise may not be present if the terms of the agreement contain conditions or permit the prospective lender or investor to establish conditions, such as interest rates or collateral requirements, that are unreasonable to the entity.</td>
</tr>
</tbody>
</table>

A financing agreement can qualify under ASC 470-10-45-14(b) even if a debtor is seeking an alternative source of financing (e.g., one that is more advantageous). Although a debtor is required to demonstrate an intent to refinance the short-term obligation on a long-term basis, such an intent can be present even if the financing agreement serves as a fallback or standby source of financing. It is sufficient that the debtor intends to use the financing agreement to refinance the short-term obligation on a long-term basis if it does not find another source of financing. However, the debtor should evaluate whether the terms of the financing agreement are reasonable. If the terms are unreasonable to the debtor (e.g., the interest rate is in excess of what the debtor is ready and willing to pay), it would be unable to assert an intent to use that financing agreement if another source of financing is not available.

Example 13-9

**Lack of Intent to Refinance Short-Term Obligation on a Long-Term Basis**

A debtor is evaluating whether it can classify a short-term obligation as a noncurrent liability under ASC 470-10-45-14(b). It has a long-term line of credit that clearly permits it to refinance the short-term obligation on a long-term basis at 15 percent per annum. Because that interest rate is significantly in excess of the interest rate the debtor expects it would have to pay if it were to enter into a similar line of credit arrangement that reflects current market interest rates, it is exploring whether to renegotiate the line of credit. However, if it is unable to obtain a reduction in the interest rate on the line of credit, the debtor expects to pay off the short-term obligation by using excess cash. In this scenario, the debtor would not be able to assert an intent to refinance the short-term obligation on a long-term basis under the line of credit because it expects to use current assets rather than the existing financing agreement to repay the short-term obligation if it is unable to renegotiate the financing agreement's terms.
13.7.4.5  Best-Efforts Remarketing Agreements

<table>
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<th>ASC 470-10</th>
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**Example 2: Classification by the Issuer of Redeemable Instruments That Are Subject to Remarketing Agreements**

**55-7** This Example illustrates the guidance for the appropriate classification by the issuer of debt if all of the following conditions exist:

a. The debt has a long-term maturity (for example, 30 to 40 years).
b. The debt holder may redeem or put the bond on short notice (7 to 30 days).
c. The issuer has a remarketing agreement that states that the agent will make its best effort to remarket the bond when redeemed.
d. The debt is secured by a short-term letter of credit that provides protection to the debt holder in the event that the redeemed debt cannot be remarketed. (Amounts drawn against the letter of credit are payable back to the issuer of the letter of credit by the issuer of the redeemable debt instrument on the same day that the drawdown occurs.)

**55-8** Debt agreements that allow a debt holder to redeem (or put) a debt instrument on demand (or within one year) should be classified as short-term liabilities despite the existence of a best-efforts remarketing agreement. That is, unless the issuer of the redeemable debt instrument has the ability and intent to refinance the debt on a long-term basis as provided for in paragraph 470-10-45-14, the debt should be classified as a current liability.

**55-9** In this Example, the obligation would be classified by the issuer as noncurrent only if the letter-of-credit arrangement meets the requirements of paragraph 470-10-45-14(b).

ASC 470-10-55-7 through 55-9 include guidance on the classification of a puttable debt obligation (such as a variable rate demand obligation) that is subject to a best-efforts remarketing agreement and short-term letter of credit. ASC 470-10-55-8 indicates that since a best-efforts remarketing agreement is not binding, its existence is not sufficient evidence of a debtor’s intent and ability to refinance a short-term obligation on a long-term basis under ASC 470-10-45-14(b) (see Section 13.7.4.2).

13.7.4.6  Subsidiary’s Ability to Rely on Parent’s Financing Agreement

Rather than have multiple subsidiaries enter into individual long-term financing agreements, a parent may enter into a single external arrangement that allows it to provide intercompany financing to its subsidiaries for all their short-term obligations to be refinanced on a long-term basis. Although there may be no formal written agreement between the parent and its individual subsidiaries that describes the terms of such a financing arrangement, the parent’s intent and ability to provide long-term financing to the subsidiary (through either an intercompany loan or an infusion of capital) would enable the subsidiary to refinance its short-term obligations on a long-term basis. The parent may provide such financing to the subsidiary by either (1) using its own working capital or (2) drawing down on the external financing agreement.
To exclude short-term obligations from current liabilities in its stand-alone financial statements, a subsidiary may use an intercompany financing arrangement with its parent to demonstrate its ability to refinance a short-term obligation on a long-term basis if the criteria in ASC 470-15-45-14 are met (see Section 13.7.4.2). For the subsidiary to meet the criteria in ASC 470-15-45-14, there must be evidence that its parent has committed a portion of its liquidity resources to servicing the subsidiary’s short-term obligation on a long-term basis. That evidence should be documented in a written intercompany financing agreement or in a confirmation of the details of the arrangement with the parent. In either case, the evidence should explicitly cover the criteria in ASC 470-10-45-14:

- The parent must be committed to providing financing to the subsidiary on terms that would allow the subsidiary to refinance the short-term obligation on a long-term basis.
- The parent must be committed to not canceling the agreement within one year (or the operating cycle) after the subsidiary’s balance sheet date for any reason that is not objectively determinable. To the extent that objectively determinable events may give rise to cancellation of the agreement, such events should be detailed in the confirmation obtained from the parent.
- The parent must be financially capable of honoring the intercompany financing agreement after taking into account all of its other obligations, including the obligation to provide financing to other subsidiaries under similar agreements.

Although the parent is not required to have an external financing agreement that meets the conditions in ASC 470-10-45-14 to demonstrate its financial capabilities, in some circumstances establishing the parent’s ability to refinance may be difficult in the absence of such agreement. In the consolidated financial statements, a subsidiary’s obligations represent obligations of the consolidated entity; therefore, the absence of an external financing agreement (or post-balance-sheet issuance of a long-term obligation or equity securities) that meets the conditions in ASC 470-10-45-14 would preclude a noncurrent classification of the subsidiary’s short-term obligations on the parent’s consolidated balance sheet.

### 13.7.5 Disclosure

<table>
<thead>
<tr>
<th>ASC 470-10</th>
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<tbody>
<tr>
<td><strong>Short-Term Obligations Expected to Be Refinanced</strong></td>
</tr>
<tr>
<td><strong>50-4</strong> If a short-term obligation is excluded from current liabilities pursuant to the provisions of this Subtopic, the notes to financial statements shall include a general description of the financing agreement and the terms of any new obligation incurred or expected to be incurred or equity securities issued or expected to be issued as a result of a refinancing.</td>
</tr>
</tbody>
</table>

When a debtor classifies a short-term obligation as a noncurrent liability under ASC 470-10-45-14, it must include a general description of the post-balance-sheet-date refinancing (see Section 13.7.3) or the financing agreement (see Section 13.7.4), as applicable.
13.7.6 Examples

13.7.6.1 Background

ASC 470-10

Example 4: Current Maturity of Long-Term Debt and Notes Payable to Be Refinanced

55-13 The following Cases illustrate various scenarios for refinancing the current portion of long-term debt and notes payable as discussed in paragraphs 470-10-45-13 through 45-20:

   a. Entity refinances on long-term basis the current maturity of long-term debt and notes payable (Case A).
   b. Laws prohibit the transfer of funds (Case B).
   c. Entity issues debentures to liquidate the debt (Case C).
   d. Entity negotiates a revolving credit agreement (Case D).
   e. Entity negotiates a revolving credit agreement with borrowing limits (Case E).
   f. Entity refinances commercial paper (Case F).
   g. Case illustrates balance sheet presentation (Case G).

ASC 470-10-55 includes multiple cases illustrating whether short-term obligations should be classified as current or noncurrent under ASC 470-10-45-14 in various refinancing scenarios. The assumptions in most of the cases are similar (see Section 13.7.6.2 below). The cases address the application of the guidance to:

   • Two post-balance-sheet-date refinancing scenarios (Case C of Example 4, and Example 5); see Section 13.7.6.3.
   • Various financing agreements (Cases A, B, D, and E of Example 4); see Section 13.7.6.4.
   • A financing agreement related to a long-term construction project (Case F of Example 4); see Section 13.7.6.5. (SAB Topic 6.H.2 also addresses this scenario.)

In addition, Case G in Example 4 illustrates balance sheet presentation; see Section 13.7.6.6.

13.7.6.2 Shared Assumptions

ASC 470-10

Example 4: Current Maturity of Long-Term Debt and Notes Payable to Be Refinanced

55-14 The Cases in this Example do not comprehend all possible circumstances and do not include all the disclosures that would typically be made regarding long-term debt or current liabilities.
Cases A through G share all of the following assumptions:

a. Entity A's fiscal year-end is December 31, 19X5.

b. The date of issuance of the December 31, 19X5, financial statements is March 31, 19X6; the Entity's practice is to issue a classified balance sheet.

c. At December 31, 19X5, short-term obligations include $5,000,000 representing the portion of 6 percent long-term debt maturing in February 19X6 and $3,000,000 of 9 percent notes payable issued in November 19X5 and maturing in July 19X6.

d. The Entity intends to refinance on a long-term basis both the current maturity of long-term debt and the 9 percent notes payable.

e. Accounts other than the long-term debt maturing in February 19X6 and the notes payable maturing in July 19X6 are as follows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$30,000,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>$50,000,000</td>
</tr>
<tr>
<td>Accounts payable and accruals</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Other long-term debt</td>
<td>$25,000,000</td>
</tr>
<tr>
<td>Shareholders' equity</td>
<td>$37,000,000</td>
</tr>
</tbody>
</table>

f. Unless otherwise indicated, the Cases also assume that the lender or prospective lender is expected to be capable of honoring the agreement, that there is no evidence of a violation of any provision, and that the terms of borrowings available under the agreement are readily determinable.

ASC 470-10-55-14 and 55-15 contain assumptions that apply to Cases A through G in Example 4 in ASC 470-10-55-16 through 55-32 (see Section 13.7.6.3 below and Section 13.7.6.4).

13.7.6.3 Post-Balance-Sheet-Date Refinancing

Example 4: Current Maturity of Long-Term Debt and Notes Payable to Be Refinanced

Case C: Entity Issues Debentures to Liquidate the Debt

55-21 In this Case, the Entity issues $8,000,000 of 10-year debentures to the public in January 19X6. The Entity intends to use the proceeds to liquidate the $5,000,000 debt maturing February 19X6 and the $3,000,000 of 9 percent notes payable maturing July 19X6. In addition, assume the debt maturing February 19X6 is paid before the issuance of the balance sheet, and the remaining proceeds from the sale of debentures are invested in a U.S. Treasury note maturing the same day as the 9 percent notes payable.

55-22 Because the Entity refinanced the long-term debt maturing in February 19X6 in a manner that meets the conditions set forth in paragraph 470-10-45-14, that obligation would be excluded from current liabilities. In addition, the 9 percent notes payable maturing in July 19X6 would also be excluded because the Entity has obtained funds expressly intended to be used to liquidate those notes and not intended to be used in current operations. In balance sheets after the date of sale of the debentures and before the maturity date of the notes payable, the Entity would exclude the notes payable from current liabilities if the U.S. Treasury note is excluded from current assets (see paragraph 210-10-45-4).

55-23 If the debentures had been sold before January 1, 19X6, the $8,000,000 of obligations to be paid would be excluded from current liabilities in the balance sheet at that date if the $8,000,000 in funds were excluded from current assets.
If, instead of issuing the 10-year debentures, the Entity had issued $8,000,000 of equity securities and all other facts in this Case remained unchanged, both the 6 percent debt due February 19X6 and the 9 percent notes payable due July 19X6 would be classified as liabilities other than current liabilities, such as Indebtedness Due in 19X6 Refinanced in January 19X6.

Example 5: Classification of a Short-Term Obligation Repaid Before Being Replaced by a Long-Term Security

This Example illustrates the guidance in paragraph 470-10-45-15.

This Example has the following assumptions:

a. An Entity has issued $3,000,000 of short-term commercial paper during the year to finance construction of a plant.

b. At June 30, 1976, the Entity's fiscal year end, the Entity intends to refinance the commercial paper by issuing long-term debt. However, because the Entity temporarily has excess cash, in July 1976 it liquidates $1,000,000 of the commercial paper as the paper matures.

c. In August 1976, the Entity completes a $6,000,000 long-term debt offering.

d. Later during the month of August, it issues its June 30, 1976, financial statements.

e. The proceeds of the long-term debt offering are to be used to do all of the following:
   1. Replenish $1,000,000 in working capital
   2. Pay $2,000,000 of commercial paper as it matures in September 1976
   3. Pay $3,000,000 of construction costs expected to be incurred later that year to complete the plant.

The $1,000,000 of commercial paper liquidated in July would be classified as a current liability in the Entity's balance sheet at June 30, 1976. The $2,000,000 of commercial paper liquidated in September 1976 but refinanced by the long-term debt offering in August 1976 would be excluded from current liabilities in balance sheets at the end of June 1976, July 1976, and August 1976. It should be noted that the existence of a financing agreement at the date the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) rather than a completed financing at that date would not change these classifications.

At the end of August 1976, $2,000,000 of cash would be excluded from current assets or, if included in current assets, a like amount of debt would be classified as a current liability.

Case C in Example 4 in ASC 470-10-55-21 through 55-24 illustrates the application of the guidance on post-balance-sheet-date refinancings in ASC 470-10-25-14(a) (see Section 13.7.3.1). Example 5 in ASC 470-10-55-33 through 55-36 illustrates the application of that guidance in a scenario in which the short-term obligation is repaid before the post-balance-sheet-date refinancing (see Section 13.7.3.2). The assumptions in ASC 470-10-55-14 and 55-15 apply to Case C (see Section 13.7.6.2).
13.7.6.4 Financing Agreements

ASC 470-10

Example 4: Current Maturity of Long-Term Debt and Notes Payable to Be Refinanced

Case A: Entity Refinances on Long-Term Basis the Current Maturity of Long-Term Debt and Notes Payable

The Entity negotiates a financing agreement with a commercial bank in December 19X5 for a maximum borrowing of $8,000,000 at any time through 19X7 with the following terms:

a. Borrowings are available at Entity A's request for such purposes as it deems appropriate and will mature three years from the date of borrowing.

b. Amounts borrowed will bear interest at the bank's prime rate.

c. An annual commitment fee of 1/2 of 1 percent is payable on the difference between the amount borrowed and $8,000,000.

d. The agreement is cancelable by the lender only if any of the following occur:
   1. The Entity's working capital, excluding borrowings under the agreement, falls below $10,000,000.
   2. The Entity becomes obligated under lease agreements to pay an annual rental in excess of $1,000,000.
   3. Treasury stock is acquired without the prior approval of the prospective lender.
   4. The Entity guarantees indebtedness of unaffiliated persons in excess of $500,000.

The Entity's intention to refinance meets the condition specified by paragraph 470-10-45-14. Compliance with the provisions listed in (d) of the preceding paragraph is objectively determinable or measurable; therefore, the condition specified by paragraph 470-10-45-14(b)(1) is met. The proceeds of borrowings under the agreement are clearly available for the liquidation of the 9 percent notes payable and the long-term debt maturing in February 19X6. Both obligations, therefore, would be classified as other than current liabilities.
**ASC 470-10 (continued)**

**55-18** Following are the liability section of Entity A’s balance sheet at December 31, 19X5, and the related note disclosures required by this Subtopic, based on the information in paragraphs 470-10-55-15 through 55-16. Because the balance sheet is issued subsequent to the February 19X6 maturity of the long-term debt, the note describes the refinancing of that obligation.

<table>
<thead>
<tr>
<th>December 31, 19X5</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Liabilities:</strong></td>
</tr>
<tr>
<td>Accounts payable and accruals</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
</tr>
<tr>
<td><strong>Long-Term Debt:</strong></td>
</tr>
<tr>
<td>9% notes payable (Note A)</td>
</tr>
<tr>
<td>6% debt due February 19X6 (Note A)</td>
</tr>
<tr>
<td>Other long-term debt</td>
</tr>
<tr>
<td>Total Long-Term Debt</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
</tr>
</tbody>
</table>

(a) These obligations may also be shown in captions distinct from both current liabilities and long-term debt, such as Interim Debt, Short-Term Debt Expected to Be Refinanced, and Intermediate Debt.

**Note A**

The Entity has entered into a financing agreement with a commercial bank that permits the Entity to borrow at any time through 19X7 up to $8,000,000 at the bank’s prime rate of interest. The Entity must pay an annual commitment fee of 1/2 of 1 percent of the unused portion of the commitment. Borrowings under the financing agreement mature three years after the date of the loan. Among other things, the agreement prohibits the acquisition of treasury stock without prior approval by the bank, requires maintenance of working capital of $10,000,000 exclusive of borrowings under the agreement, and limits the annual rental under lease agreements to $1,000,000. In February 19X6, the Entity borrowed $5,000,000 at 8 percent and liquidated the 6 percent long-term debt, and it intends to borrow additional funds available under the agreement to refinance the 9 percent notes payable maturing in July 19X6.

**Case B: Laws Prohibit the Transfer of Funds**

**55-19** A foreign subsidiary of the Entity negotiates a financing agreement with its local bank in December 19X5. Funds are available to the subsidiary for its unrestricted use, including loans to affiliated entities; other terms are identical to those cited in Case A. Local laws prohibit the transfer of funds outside the country.

**55-20** The requirement of paragraph 470-10-45-14(b)(1) is met because compliance with the provisions of the agreement is objectively determinable or measurable. Because of the laws prohibiting the transfer of funds, however, the proceeds from borrowings under the agreement are not available for liquidation of the debt maturing in February and July 19X6. Accordingly, both the 6 percent debt maturing in February 19X6 and the 9 percent notes payable maturing in July 19X6 would be classified as current liabilities.
### Case D: Revolving Credit Agreement

**55-25** In December 19X5 the Entity negotiates a revolving credit agreement providing for unrestricted borrowings up to $10,000,000. Borrowings will bear interest at 1 percent over the prevailing prime rate of the bank with which the agreement is arranged but in any event not less than 8 percent, will have stated maturities of 90 days, and will be continuously renewable for 90-day periods at the Entity's option for 3 years provided there is compliance with the terms of the agreement. Provisions of the agreement are similar to those cited in paragraph 470-10-55-16(d). Further, the Entity intends to renew obligations incurred under the agreement for a period extending beyond one year from the balance sheet date. There are no outstanding borrowings under the agreement at December 31, 19X5.

**55-26** In this instance, the long-term debt maturing in February 19X6 and the 9 percent notes payable maturing in July 19X6 would be excluded from current liabilities because the Entity consummated a financing agreement meeting the conditions set forth in paragraph 470-10-45-14(b) before the issuance of the balance sheet.

### Case E: Revolving Credit Agreement with Borrowing Limits

**55-27** Assume that the agreement cited in Case D included an additional provision limiting the amount to be borrowed by the Entity to the amount of its inventory, which is pledged as collateral and is expected to range between a high of $8,000,000 during the second quarter of 19X6 and a low of $4,000,000 during the fourth quarter of 19X6.

**55-28** The terms of the agreement comply with the conditions required by this Subtopic; however, because the minimum amount expected to be available from February to December 19X6 is $4,000,000, only that amount of short-term obligations can be excluded from current liabilities (see paragraphs 470-10-45-16 through 45-19). Whether the obligation to be excluded is a portion of the currently maturing long-term debt or some portions of both it and the 9 percent notes payable depends on the intended timing of the borrowing.

**55-29** If the Entity intended to refinance only the 9 percent notes payable due July 19X6 and the amount of its inventory is expected to reach a low of approximately $2,000,000 during the second quarter of 19X6 but be at least $3,000,000 in July 19X6 and thereafter during 19X6, the $3,000,000 9 percent notes payable would be excluded from current liabilities at December 31, 19X5 (see paragraphs 470-10-45-16 through 45-19).

Cases A, B, D, and E in Example 4 in ASC 470-10-55-16 through 55-20 and ASC 470-10-55-25 through 55-29 illustrate the application of the guidance on financing agreements in ASC 470-10-25-14(b) (see Section 13.7.4). The assumptions in ASC 470-10-55-14 and 55-15 (see Section 13.7.6.2) apply to these cases. Further, Cases B and E illustrate the application of the guidance on the limits on the amount that can be classified as noncurrent when the amount available under the financing agreement is subject to transfer restrictions or fluctuates (see Section 13.7.4.3).
13.7.6.5 *Financing Agreements Related to Long-Term Construction Projects*

**Example 4: Current Maturity of Long-Term Debt and Notes Payable to Be Refinanced**

Case F: Commercial Paper Refinancing

**55-30** In lieu of the facts given in paragraph 470-10-55-15(c) through (d), assume that during 19X5 the Entity entered into a contract to have a warehouse built. The warehouse is expected to be financed by issuance of the Entity's commercial paper. In addition, the Entity negotiated a standby agreement with a commercial bank that provides for maximum borrowings equal to the expected cost of the warehouse, which will be pledged as collateral. The agreement also requires that the proceeds from the sale of commercial paper be used to pay construction costs. Borrowings may be made under the agreement only if the Entity is unable to issue new commercial paper. The proceeds of borrowings must be used to retire outstanding commercial paper and to liquidate additional liabilities incurred in the construction of the warehouse. At December 31, 19X5, the Entity has $7,000,000 of commercial paper outstanding and $1,000,000 of unpaid construction costs resulting from a progress billing through December 31.

**55-31** Because the commercial paper will be refinanced on a long-term basis, either by uninterrupted renewal or, failing that, by a borrowing under the agreement, the commercial paper would be excluded from current liabilities. The $1,000,000 liability for the unpaid progress billing results from the construction of a noncurrent asset and will be refinanced on the same basis as the commercial paper and, therefore, it would also be excluded from current liabilities (see paragraph 470-10-45-13).

**SEC Staff Accounting Bulletins**

SAB Topic 6.H.2, Classification of Short-Term Obligations — Debt Related to Long-Term Projects [Reproduced in ASC 470-10-S99-3]

Facts: Companies engaging in significant long-term construction programs frequently arrange for revolving cover loans which extend until the completion of long-term construction projects. Such revolving cover loans are typically arranged with substantial financial institutions and typically have the following characteristics:

1. A firm long-term mortgage commitment is obtained for each project.
2. Interest rates and terms are in line with the company's normal borrowing arrangements.
3. Amounts are equal to the expected full mortgage amount of all projects.
4. The company may draw down funds at its option up to the maximum amount of the agreement.
5. The company uses short-term interim construction financing (commercial paper, bank loans, etc.) against the revolving cover loan. Such indebtedness is rolled over or drawn down on the revolving cover loan at the company's option. The company typically has regular bank lines of credit, but these generally are not legally enforceable.

Question: Under FASB ASC Subtopic 470-10, Debt — Overall, will the classification of loans such as described above as long-term be acceptable?

Interpretive Response: Where such conditions exist providing for a firm commitment throughout the construction program as well as a firm commitment for permanent mortgage financing, and where there are no contingencies other than the completion of construction, the guideline criteria are met and the borrowing under such a program should be classified as long-term with appropriate disclosure.

Case F in Example 4 in ASC 470-10-55-30 and 55-31 and SAB Topic 6.H.2 illustrate the application of the guidance on financing agreements in ASC 470-10-25-14(b) (see Section 13.7.4) to scenarios that involve short-term interim financing to fund long-term construction projects. The assumptions in ASC 470-10-55-14 and 55-15 (see Section 13.7.6.2) apply to Case F except as specified in ASC 470-10-55-30.
This guidance illustrates that a short-term interim financing (e.g., commercial paper, bank loans) can be classified as noncurrent if a financing agreement (e.g., a firm, revolving long-term mortgage commitment for the construction project) meets the conditions in ASC 470-10-45-14(b). The fact that the financing agreement is contingent on the completion of construction is not relevant.

### 13.7.6.6 Balance Sheet Presentation

**ASC 470-10**

**Example 4: Current Maturity of Long-Term Debt and Notes Payable to Be Refinanced**

**Case G: Balance Sheet Presentation**

55-32 The following are two methods of presenting liabilities in Entity A’s balance sheet at December 31, 19X5, assuming the Entity intends to refinance the 6 percent debt maturing in February 19X6 and the 9 percent notes payable maturing in July 19X6 but has not met the conditions required by this Subtopic to exclude those obligations from current liabilities.

**Alternative 1**

<table>
<thead>
<tr>
<th>December 31, 19X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities:</td>
</tr>
<tr>
<td>Accounts payable and accruals</td>
</tr>
<tr>
<td>Notes payable, due July 19X6</td>
</tr>
<tr>
<td>6% debt due February 19X6</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
</tr>
<tr>
<td>Long-Term Debt</td>
</tr>
<tr>
<td>Total Liabilities</td>
</tr>
</tbody>
</table>

**Alternative 2**

<table>
<thead>
<tr>
<th>December 31, 19X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities:</td>
</tr>
<tr>
<td>Accounts payable and accruals</td>
</tr>
<tr>
<td>Short-term debt expected to be refinanced:</td>
</tr>
<tr>
<td>Notes payable, due July 19X6</td>
</tr>
<tr>
<td>6% debt due February 19X6</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
</tr>
<tr>
<td>Long-Term Debt</td>
</tr>
<tr>
<td>Total Liabilities</td>
</tr>
</tbody>
</table>

Case G in Example 4 in ASC 470-10-55-32 illustrates the appropriate balance sheet presentation based on the assumptions in ASC 470-10-55-14 and 55-15 (see Section 13.7.6.2).
13.8 Revolving Debt

13.8.1 Background

ASC 470-50 — Glossary

**Line-of-Credit Arrangement**

A line-of-credit or revolving-debt arrangement is an agreement that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then reborrow under the same contract. Line-of-credit and revolving-debt arrangements may include both amounts drawn by the debtor (a debt instrument) and a commitment by the creditor to make additional amounts available to the debtor under predefined terms (a loan commitment).

A revolving-debt arrangement is an agreement under which borrowed amounts that are repaid can be reborrowed. That is, the potential debtor can make multiple borrowings up to a specified maximum amount, repay borrowed amounts, and reborrow. Some, but not all, revolving-debt arrangements contain a lockbox feature with which remittances made by the debtor’s customers are used to repay the debtor’s outstanding debt obligation (see Sections 13.3.4.7 and 13.3.4.8). Section 13.8.2 below discusses the classification of a revolving-debt arrangement without a lockbox feature, and Section 13.8.3 addresses revolving-debt arrangements with a lockbox feature.

13.8.2 Revolving Debt Without Lockbox Feature

**ASC 470-10**

45-4 Borrowings outstanding under certain revolving credit agreements are considered long-term debt because the borrowings are due at the end of a specified period (for example, 3 years) rather than when short-term notes roll over (for example, every 90 days). Borrowings may be collateralized, but the only note is the overall note signed at the agreement’s inception.

Nonauthoritative AICPA Guidance

**Technical Q&As Section 3200, “Long-Term Debt”**

12 Balance Sheet Classification of Revolving Line of Credit

**Inquiry** — A company has a revolving line of credit with a bank. The company is only required to make monthly interest payments. No principal payments are required. In the event the credit line is terminated, the principal is due 12 months after the date of termination.

Should the principal amount be classified as current or long-term in a classified balance sheet?

**Reply** — Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 210-10-45-9 states that liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, are intended for inclusion in the current liability classification. If the line of credit has not been terminated at the balance sheet date, the principal amount should be classified as long-term, unless the company intends to repay the outstanding debt within 12 months.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]
Borrowings under a revolving-debt agreement without a lockbox feature are classified as current or noncurrent in the same manner as nonrevolving-debt obligations. Generally, such borrowings are classified as current liabilities if (1) they are scheduled to mature within one year (or the operating cycle, if longer), (2) the creditor could demand earlier repayment (see Sections 13.4 and 13.5), or (3) it is probable that a SAC will be exercised (see Section 13.6). However, a revolving-debt agreement would qualify as a noncurrent liability if the debtor can demonstrate its intent and ability to refinance the obligation on a long-term basis (see Section 13.7) or, in the case of a long-term revolving-debt agreement for which a covenant violation has occurred, either of the exceptions for covenant waivers and grace periods applies (see Section 13.5.3). ASC 470-10-55-25 and 55-26 illustrate a scenario in which a long-term revolving-credit agreement is used to demonstrate an intent and ability to refinance a short-term obligation on a long-term basis (see Section 13.7.6.4).

13.8.3 Revolving Debt With Lockbox Feature

Some debt agreements require the debtor to establish a lockbox with the creditor. ASC 470-10-45-5 and 45-6 draw a distinction between traditional and springing lockbox features.

13.8.3.1 Traditional Lockbox Arrangements

Whether a revolving-debt obligation that contains a traditional lockbox arrangement can be classified as a noncurrent liability depends on the circumstances, including whether the debt agreement has a SAC and whether repayments made through the lockbox arrangement can be considered refinanced on a long-term basis in accordance with ASC 470-10-45-13 through 45-21 (see Section 13.7.4).

13.8.3.2 Springing Lockbox Arrangements

Because customer remittances paid to a lockbox in a revolving-credit arrangement that incorporates a springing lockbox feature (see Section 13.3.4.8) are not used to pay down the debtor's obligation unless the springing lockbox is triggered, a revolving-credit arrangement that is not repayable within one year (or the operating cycle, if longer) generally is considered a long-term obligation under ASC 470-10 even if it contains a springing lockbox feature (see ASC 470-10-45-6).

Springing lockbox arrangements usually include a SAC (see Section 13.3.4.6) that, if exercised, allows the creditor to cause the cash in the lockbox at that moment, as well as all subsequent customer lockbox remittances, to be applied against the debtor's outstanding debt balance. That is, once the creditor exercises the SAC, in addition to acceleration of the debt, the springing lockbox arrangement will function like a traditional lockbox agreement (see Section 13.3.4.7). Therefore, the debtor must consider the guidance on SACs in long-term obligations (see Section 13.6).

Borrowings under revolving-debt arrangements with a springing lockbox feature are classified as noncurrent liabilities if they are scheduled to mature one year (or the operating cycle, if applicable) after the balance sheet date unless (1) the creditor could demand earlier repayment (see Sections 13.4 and 13.5) or (2) it is probable that a SAC will be exercised (see Section 13.6). If a covenant violation has occurred that makes the debt repayable within one year (or the operating cycle, if longer) after the balance sheet date, the debtor should also consider whether the debt can be classified as noncurrent under the guidance on waiver exceptions and grace periods (see Section 13.5.3).
Borrowings under revolving debt arrangements with a springing lockbox feature are classified as current liabilities if (1) they are scheduled to mature within one year (or the operating cycle, if longer), (2) the creditor could demand earlier repayment (see Sections 13.4 and 13.5), or (3) it is probable that a SAC will be exercised (see Section 13.6). However, such borrowings qualify as noncurrent liabilities if the debtor can demonstrate its intent and ability to refinance the obligation on a long-term basis (see Section 13.7) or, in the case of a covenant violation, either of the exceptions for covenant waivers and grace periods applies (see Section 13.5.3).

### 13.8.3.3 Revolving Debt With Lockbox Feature and SAC

<table>
<thead>
<tr>
<th>ASC 470-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-3</strong> This guidance does not apply to lock-box arrangements that are maintained at the discretion of the borrower.</td>
</tr>
<tr>
<td><strong>45-4</strong> Some agreements require that the borrower maintain a lock-box arrangement. If borrowings outstanding under the agreement are considered long-term obligations, the effect of a subjective acceleration clause on balance sheet classification is determined based on the criteria in paragraph 470-10-45-2. If borrowings outstanding are considered short-term obligations, and the borrower intends to refinance the obligation on a long-term basis, paragraph 470-10-45-13 applies and the debt shall be classified as a current liability because of the existence of the subjective acceleration clause.</td>
</tr>
<tr>
<td><strong>45-5</strong> Borrowings outstanding under a revolving credit agreement that includes both a subjective acceleration clause and a requirement to maintain a lock-box arrangement shall be considered short-term obligations. Accordingly, because of the subjective acceleration clause, the debt shall be classified as a current liability unless the conditions in paragraph 470-10-45-14 are met based on an agreement, other than the revolving credit agreement, to refinance the obligation after the balance sheet date on a long-term basis.</td>
</tr>
<tr>
<td><strong>45-6</strong> Borrowings outstanding under a revolving credit agreement that includes both a subjective acceleration clause and a requirement to maintain a springing lock-box arrangement shall be considered long-term obligations since the remittances do not automatically reduce the debt outstanding without another event occurring. The effect of the agreement's subjective acceleration clause shall be determined based on the provisions of paragraph 470-10-45-2.</td>
</tr>
<tr>
<td><strong>45-21</strong> Replacement of a short-term obligation with another short-term obligation after the date of the balance sheet but before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25) is not, by itself, sufficient to demonstrate an entity's ability to refinance the short-term obligation on a long-term basis. If, for example, the replacement is made under the terms of a revolving credit agreement that provides for renewal or extension of the short-term obligation for an uninterrupted period extending beyond one year (or operating cycle) from the date of the balance sheet, the revolving credit agreement must meet the conditions in paragraph 470-10-45-14(b) to justify excluding the short-term obligation from current liabilities. . . .</td>
</tr>
</tbody>
</table>

A revolving-credit arrangement with a traditional lockbox feature (see Section 13.3.4.7) is considered a short-term obligation. Under ASC 470-10-45-14, short-term obligations are classified as noncurrent liabilities if the borrower has the intent and ability to refinance such obligations on a long-term basis (see Section 13.7). However, the existence of a SAC within a revolving-debt arrangement disqualifies the entity from using the revolving-debt arrangement as the means to refinance the obligation on a long-term basis even if the revolving debt arrangement does not expire within one year (or the operating cycle, if longer) after the balance sheet date. Accordingly, a revolving-credit agreement that incorporates both a traditional lockbox feature and a SAC must be classified as a current liability unless the conditions in ASC 470-10-45-14 are met on the basis of an agreement other than the revolving-debt arrangement (see Section 13.7). (As discussed in Section 13.7.4, a long-term revolving-debt agreement with a traditional lockbox feature that does not have a SAC may meet the conditions in ASC 470-10-45-14(b).)
If a long-term revolving-debt arrangement incorporates a springing lockbox feature (see Section 13.3.4.8) and a SAC (see Section 13.3.4.6), the classification of the related borrowings depends on the likelihood that the SAC will be exercised. If exercise of the SAC is probable, the revolving-debt arrangement must be classified as a current liability unless the conditions in ASC 470-10-45-14 are met on the basis of an agreement other than the revolving-debt arrangement (see Section 13.7). The impact of lockbox features and SACs on the classification of a revolving-credit agreement is summarized in the following decision tree:

2 Remittances from the borrower’s customers are forwarded to the debtor’s general bank account and not used to reduce the outstanding debt unless or until the lender exercises the SAC (ASC 470-10-45-6).
3 Classify the borrowing as a current liability unless the ability to refinance the liability for a long-term period comes from an agreement other than the revolving-credit agreement.
13.9 Increasing-Rate Debt

**ASC 470-10**

45-7 Classification of increasing-rate debt as current or noncurrent would reflect the borrower’s anticipated source of repayment that is, current assets or a new short-term debt borrowing versus a long-term refinancing agreement that meets the requirements of this Subtopic and need not be consistent with the time frame used to determine periodic interest cost.

The manner in which increasing-rate extendable debt is classified as current or noncurrent is not necessarily consistent with how periodic interest cost is determined under ASC 470-10-35-1 and 35-2 (see Section 6.2.4.5). Rather, increasing-rate extendable debt should be classified as current or noncurrent on the basis of the same general guidance in ASC 470-10 that applies to all other debt instruments. The debtor may therefore need to consider whether a refinancing arrangement meets the requirements in ASC 470-10-45-14 (see Section 13.7).

13.10 Convertible Debt

**ASC 470-20**

45-3 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.

**Nonauthoritative AICPA Guidance**

**Technical Q&As Section 1100, “Statement of Financial Position”**

14 Classification of Convertible Debt

*Inquiry* — A company has debt that is convertible into common stock of the company at the option of the company. The debt by its terms is considered long-term debt in the classified balance sheet. The company intends to call the debt and issue the common stock within one year of the balance sheet date. Should this debt be classified as a current liability?

*Reply* — No. The expected call of the debt securities will not consume current assets or increase current liabilities, and accordingly should continue to be classified as a long-term obligation.

The general principle underlying the classification of debt in a debtor’s principal balance sheet should be based on facts existing at the date of the balance sheet rather than on expectations. According to FASB Accounting Standards Codification (ASC) glossary, the term current liabilities “is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.”
The classification of convertible debt as current or noncurrent depends on the terms of the debt. Current liabilities generally include convertible debt obligations for which payment of cash or other current assets or the creation of current liabilities could be required within one year (or the operating cycle, if longer) after the balance sheet date. Unless debt has met the requirements related to short-term obligations expected to be refinanced on a long-term basis (see Section 13.7), current classification is necessary for:

- Convertible debt that is scheduled to mature within one year (or the operating cycle, if longer) after the balance sheet date (see Section 13.3).
- Any portion of long-term convertible debt that is scheduled to mature within one year (or the 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; see Section 13.3).
- Convertible debt that is repayable on demand or puttable by the holder within one year (or the operating cycle, if longer) after the balance sheet date (see Section 13.4), including convertible debt that is contingently puttable if the contingency has been met.
- Long-term convertible debt that became repayable on demand or within one year (or the operating cycle, if longer) after the balance sheet date because of a covenant violation that occurred as of the balance sheet date or before the financial statements were issued or available to be issued (see Section 13.5). Note that the issuer should consider whether either of the exceptions for covenant waivers and grace periods is applicable (see Section 13.5.3).
- The cash-settled portion of debt that is convertible at any time or within one year (or the operating cycle, if longer) after the balance sheet date if the issuer is or could be required to settle all or part of the conversion value in cash upon conversion (e.g., Instrument A and Instrument C; see Section 7.6.4.1). Such debt is treated as debt that is repayable on demand (see Section 13.4) even if the conversion option is out-of-the-money.

If debt is convertible at any time or within one year after the balance sheet date and the issuer has the right to settle the conversion value in cash or shares or any combination thereof (e.g., Instrument X; see Section 7.6.4.1), the entity should consider its intended settlement method. If the convertible debt instrument allows the entity to pay the accreted value in cash or stock or any combination thereof, the diluted EPS treatment depends on whether the entity 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. 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.

Generally, the holder’s conversion option does not affect the classification of convertible debt as current or noncurrent if it must be settled by the delivery of the issuer’s equity shares (see Section 13.3.3.4).
13.11 Long-Term Obligations That Debtor Repays or Intends to Repay After the Balance Sheet Date

ASC 470-10 does not require an entity to classify a long-term debt obligation as a current liability on the basis that the entity expects to settle the debt within one year (or the operating cycle, if longer) after the balance sheet date (e.g., the debtor expects to exercise an early repayment option such as an embedded call option in the debt). While ASC 210-10-45-9 states that liabilities whose “ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months,” are intended for inclusion in the current liability classification, noncurrent classification is appropriate when a debt obligation meets the conditions for long-term classification even if the debtor intends to repay it within one year (or the operating cycle, if longer) after the balance sheet date. That is, if the debtor controls the ability to not repay the debt obligation within one year (or the operating cycle, if longer) after the balance sheet date, the debt represents a noncurrent liability notwithstanding the debtor’s intent to repay it within one year (or the debtor’s actual repayment of the liability after the balance sheet date and before the financial statements are issued or available to be issued). This is consistent with paragraph 13 of the Background Information and Basis for Conclusions of FASB Statement 78, which specifically states that “as a general principle, classification of debt in a debtor’s balance sheet should be based on facts existing at the balance sheet date rather than on expectations.” Therefore, a debt repayment that occurs after the balance sheet date but before the financial statements are issued or available to be issued represents a nonrecognized subsequent event under ASC 855-10-25-3.

However, on the basis of observed diversity in practice, it would be acceptable for a debtor to classify a debt obligation as current that otherwise meets the conditions for noncurrent classification when both of the following conditions are met:

- The debtor either (1) has the ability and intent to repay the obligation within one year (or the operating cycle, if longer) after the balance sheet date or (2) repays the obligation after the balance sheet date but before the financial statements were issued or available to be issued.
- The repayment of the debt is made with assets that were classified as current as of the balance sheet date (e.g., the debtor did not repay the debt by refinancing it with the issuance of replacement long-term debt).

This alternative view would be considered acceptable and consistent with the nonauthoritative guidance in AICPA Technical Q&As Section 3200.12, which refers to classification of a long-term debt obligation as current on the basis of an intent to repay it within 12 months after the balance sheet date. However, if an entity applies this alternative, it should appropriately disclose the rationale for the classification of the debt as a current liability as of the balance sheet date.

13.12 Presentation

13.12.1 Balance Sheet Presentation

<table>
<thead>
<tr>
<th>ASC 210-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-5 A total of current liabilities shall be presented in classified balance sheets.</td>
</tr>
</tbody>
</table>

In a classified balance sheet, current liabilities are presented separately from noncurrent liabilities, with a summation of each total. SEC Regulation S-X, Rule 5-02 (reproduced in ASC 210-10-599-1), requires SEC registrants within the scope of that rule (i.e., commercial and industrial companies) to present long-term debt separately from current liabilities when filing financial statements with the SEC. Case G in Example 4 in ASC 470-10-55-32 illustrates the appropriate balance sheet presentation based on the assumptions in ASC 470-10-55-14 and 55-15 (see Section 13.7.6.6).
Chapter 13 — Balance Sheet Classification

13.12.2 Subsidiary’s and Parent’s Fiscal Years Differ

ASC 470-10 — SEC Materials — SEC Staff Guidance

Comments Made by SEC Observer at Emerging Issues Task Force (EITF) Meetings
SEC Observer Comment: Classification of Subsidiary’s Loan Payable in Consolidated Balance Sheet when Subsidiary’s and Parent’s Fiscal Years Differ
S99-4 The following is the text of SEC Observer Comment: Classification of Subsidiary’s Loan Payable in Consolidated Balance Sheet when Subsidiary’s and Parent’s Fiscal Years Differ.

Issues periodically occur related to classification of a subsidiary’s loan payable in a consolidated balance sheet when the subsidiary’s and parent’s fiscal years differ. For example, assume that a consolidated balance sheet prepared as of February 29, 1988, comprised of the parent company’s balance sheet as of that date and the subsidiary’s balance sheet as of December 31, 1987. The subsidiary’s balance sheet included a material loan payable to a bank due January 31, 1989. The SEC staff would expect the debt in this case to be classified as current because to do otherwise would result in a material misclassification.

A subsidiary’s fiscal year may end before that of its parent. As a result, a subsidiary may have debt that becomes due more than one year (or the operating cycle, if longer) after the subsidiary’s balance sheet date but less than one year (or the operating cycle, if longer) after the parent’s balance sheet date. ASC 470-10-S99-4 includes the SEC staff’s views about the classification in this situation. If a debt obligation matures less than one year (or the operating cycle, if longer) after the parent’s balance sheet date, the debt should be classified as a current liability in the parent’s consolidated balance sheet.

13.12.3 Comparative Financial Statements

Nonauthoritative AICPA Guidance

Technical Q&As Section 3200, “Long-Term Debt”
.13 Uncertainty Arising From Violation of Debt Agreement
Inquiry — At the end of 20X1, a company was in violation of its long-term debt covenant and was unable to obtain a waiver from the bank. It therefore reclassified its debt to current and appropriate footnote disclosures were made. During 20X2, the violation was cured. What is the proper classification of the debt in the company’s 20X2 comparative financial statements?

Reply — . . . Since the violation was cured in 20X2, the debt should be classified as long-term in the 20X2 financial statements. The debt should not be reclassified to long term in the 20X1 financial statements because it was a current liability based on the facts existing at the 20X1 balance sheet date. . . .

AICPA Technical Q&As Section 3200.13 clarifies that when an entity presents comparative financial statements, it should not retrospectively reclassify debt as noncurrent if the debt was appropriately classified as current when those financial statements were first issued. The specific situation addressed in Technical Q&As Section 3200.13 is one in which the debtor (1) violated a covenant, which caused the debt to become repayable as of the 20X1 balance sheet date (see Section 13.5), and (2) did not obtain a waiver from the creditor before the 20X1 financial statements were issued (see Section 13.5.3). Accordingly, the debt was classified as current in the 20X1 financial statements. The debtor cured the violation in 20X2 so that the debt qualified for noncurrent classification in the 20X2 financial statements. Nevertheless, the debtor could not reclassify the debt as noncurrent in its 20X2 comparative financial statements for 20X1.
Chapter 14 — Presentation, Disclosure, and Other Considerations

14.1 Background
This chapter briefly discusses accounting, presentation, and disclosure matters that are not addressed elsewhere in the Roadmap.

14.2 Accounting
14.2.1 Hedge Accounting
14.2.1.1 General
This section discusses how the accounting for debt might be affected by the application of hedge accounting.

14.2.1.2 Debt Designated as Hedged Item in Fair Value Hedge
When the qualifying criteria for hedge accounting are met, ASC 815-20-25-12(f) permits an entity to designate debt (such as fixed-rate debt) as a hedged item in a fair value hedge. The debtor is permitted to designate the hedged risk as the risk of changes in (1) the debt's fair value in its entirety or (2) the portion of the debt's fair value attributable to changes in (a) a designated benchmark interest rate (interest rate risk), (b) foreign currency exchange rates (foreign exchange risk), or (c) changes in credit risk (such as the credit spread over the benchmark interest rate). Under ASC 815-20-25-12(b), a debtor is permitted to designate a portfolio of similar liabilities, a percentage of an entire liability, or the contractual cash flows of one or more liability as the hedged item (e.g., a partial-term interest rate risk hedge of the first 5 years of 10-year debt by using an assumed term for the debt that matches the hedged payments; see ASC 815-25-35-13B). Further, a debtor is permitted to designate a benchmark rate component of the contractual cash flows determined at hedge inception as the hedged item in an interest rate risk hedge of debt (ASC 815-25-35-13). However, a debtor cannot designate a fair value hedge related to a risk of changes in the debt's fair value that is recognized in earnings, such as interest rate risk related to debt for which the fair value option in ASC 815-15 or ASC 825-10 has been elected or foreign exchange risk related to foreign-denominated debt that is remeasured at spot rates under ASC 830-20 (ASC 815-20-25-43(c)(3)).

When fair value hedge accounting is applied, the change in the debt's fair value attributable to the hedged risk is recognized as an adjustment to the debt's carrying amount, with an offsetting entry to earnings (ASC 815-25-35-1(b)). Except for excluded components, which are amortized to earnings, gains and losses on the hedging instrument are recognized immediately in earnings (ASC 815-25-35-1(a)). All amounts recognized in earnings are presented in the same line item as the earnings effect of the hedged item (e.g., interest expense). An adjustment to the debt's carrying amount is amortized to interest expense and must begin no later than the debt ceases to be adjusted for changes in its fair
value attributable to the hedged risk (ASC 815-25-35-9). When a debtor uses a pay-variable, receive-fixed interest rate swap to hedge debt and the conditions for the shortcut method are met (see ASC 815-20-25-104 and 25-105), the change in fair value of the hedged debt attributable to the risk being hedged does not need to be directly measured. Instead, the change in the fair value of the derivative hedging instrument adjusts the carrying amount of the hedged debt, and interest expense is recognized on the basis of the variable rate of the swap, adjusted for any difference between the fixed rate on the swap and that on the hedged debt (ASC 815-25-55-43).

Fair value hedge accounting must be discontinued prospectively if the hedging relationship no longer meets the criteria for fair value hedge accounting (e.g., the hedge is no longer expected to be highly effective), the debtor dedesignates the hedge, or the derivative expires or is sold, terminated (except for certain novations), or exercised (ASC 815-25-40-1).

14.2.1.3 Debt Designated as Hedged Item in Cash Flow Hedge

When the qualifying criteria for hedge accounting are met, an entity is permitted under ASC 815-20-25-15(j) to designate probable variable cash flows associated with existing debt (such as variable-rate debt or foreign-denominated fixed-rate debt) or a probable forecasted purchase or issuance of debt (or probable interest payments on such debt) as a hedged item in a cash flow hedge. The debtor is permitted to designate the hedged risk as the risk of changes in (1) overall changes in the hedged cash flows, (2) forecasted variable-rate interest payments associated with existing debt and attributable to changes in a contractually specified interest rate (interest rate risk), (3) forecasted cash flows associated with the forecasted issuance of debt (or the forecasted interest payments) and attributable to changes in a benchmark interest rate or an expected contractually specified interest rate, (4) the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rate (foreign exchange risk), or (5) the risk of changes in cash flows attributable to credit risk (e.g., changes in the credit spread over the contractually specified interest rate or the benchmark interest rate). However, a debtor cannot designate a cash flow hedge related to existing debt or the forecasted issuance of debt if the debt is remeasured, with changes in fair value attributable to the hedged risk recognized in earnings, such as foreign exchange risk related to foreign-denominated debt that is remeasured at spot rates under ASC 830-20 (see ASC 815-20-25-15(d) and (e)).

When cash flow hedge accounting is applied, the accounting for the hedged item is not altered. Instead, gains and losses on the hedging instrument related to the hedged risk are recognized in OCI and reclassified to earnings in the same period or periods during which the hedged forecasted transaction affects earnings (ASC 815-30-35-3 and ASC 815-30-35-38). That reclassification and the amount recognized in earnings for any excluded components are presented in the same income statement line item as the earnings effect of the hedged item (e.g., interest expense).

Cash flow hedge accounting must be discontinued prospectively if the hedging relationship no longer meets the criteria for cash flow hedge accounting (e.g., the hedge is no longer expected to be highly effective), the debtor dedesignates the hedge, or the derivative expires or is sold, terminated (except for certain novations), or exercised (ASC 815-25-40-1). However, in accordance with ASC 815-30-40-4, the amount in AOCI related to a discontinued hedge is not reclassified to earnings unless both (1) “it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter” and (2) no rare, “extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity ... cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two-month period of time.” Further, under ASC 815-30-40-5, “[a] pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity’s ability to accurately
predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.”

14.2.1.4 Debt Designated as Hedging Instrument in Foreign Currency Fair Value Hedge of a Firm Commitment

When the qualifying criteria for hedge accounting are met, ASC 815-20-25-58 permits an entity to designate foreign-denominated debt as a hedging instrument in a foreign currency fair value hedge of an unrecognized firm commitment or a portion thereof (e.g., a firm commitment to purchase or sell a nonfinancial item). ASC 815-20 does not address how to account for such debt (see ASC 815-20-25-59). Instead, an entity applies ASC 830-20, which requires foreign-denominated debt to be remeasured at spot rates (see Section 14.2.3). Certain foreign-denominated intraentity loans for which an offsetting third-party loan is in place can also be designated as a hedging instrument in a foreign currency fair value hedge of an unrecognized firm commitment or a portion thereof (see ASC 815-20-25-60).

14.2.1.5 Debt Designated as Hedging Instrument in Net Investment Hedge

When the qualifying criteria for hedge accounting are met, ASC 815-20-25-66 permits an entity to designate foreign-denominated debt as a hedging instrument in a foreign currency hedge of a net investment in a foreign operation. However, such designation cannot be applied if the debt is accounted for at fair value through earnings. When net investment hedge accounting is applied, the foreign currency transaction gain or loss on the debt (i.e., the remeasurement of the debt at spot rates) under ASC 835-30 (see Section 14.2.3) is recognized in OCI in a manner similar to a translation adjustment associated with the hedged net investment (see ASC 815-35-35-1 and ASC 815-35-35-12). The cumulative translation adjustment is recognized in earnings in accordance with ASC 830-30-40 (see Section 5.4 of Deloitte’s A Roadmap to Foreign Currency Transactions and Translations).

14.2.2 Fair Value Measurements

Sometimes, the accounting for debt involves fair value measurements (e.g., the initial measurement of debt that is initially measured by using present value techniques under ASC 835-30, debt accounted for at fair value by using the fair value option in ASC 815-15 or ASC 825-10, the measurement of bifurcated embedded derivatives under ASC 815-15, debt that is designated as a hedged item in a fair value hedge under ASC 815-20 and ASC 815-25, and initial measurements in transactions that include multiple units of accounts). In determining fair value, an entity should apply the guidance in ASC 820. In the absence of a specific exception, ASC 820 applies whenever fair value measurements or disclosures are permitted or required under GAAP (see ASC 820-10-15-1).

For a detailed discussion of the guidance in ASC 820, see Deloitte’s A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option). That Roadmap addresses fair value measurement considerations specific to notes payable (Section 2.3.1), hedged items in fair value hedges (Section 2.3.11), liabilities and instruments classified in equity (Section 10.2.7), fair value disclosures (Chapter 11), and the application of the fair value option (Chapter 12).
### 14.2.3 Foreign Currency Matters

**ASC 830-20**

35-1 A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes.

35-2 At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of the recording entity shall be adjusted to reflect the current exchange rate. At a subsequent balance sheet date, the current rate is that rate at which the related receivable or payable could be settled at that date. Paragraphs 830-20-30-2 through 30-3 provide more information about exchange rates.

Under ASC 830-20, a debtor is required to remeasure the carrying amount of debt that is denominated in a currency other than its functional currency as of each reporting date by using the current exchange rate. Because debt issuance costs are presented as a reduction of the debt's carrying amount, the remeasurement should be based on the carrying amount after deduction of any remaining unamortized debt issuance costs. Accordingly, the debt's carrying amount will change each reporting date (until the debt is extinguished) as a result of changes in exchange rates. Generally, the changes in the net carrying amount are recognized in earnings as transaction gains or losses. For additional discussion of the application of ASC 830, see Deloitte’s *A Roadmap to Foreign Currency Transactions and Translations*.

### 14.2.4 Capitalization of Interest

**ASC 835-20**

15-5 Interest shall be capitalized for the following types of assets (qualifying assets):

a. Assets that are constructed or otherwise produced for an entity's own use, including assets constructed or produced for the entity by others for which deposits or progress payments have been made.

b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (for example, ships or real estate developments).

c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The investor's investment in the investee, not the individual assets or projects of the investee, is the qualifying asset for purposes of interest capitalization.

30-3 The amount capitalized in an accounting period shall be determined by applying the capitalization rate to the average amount of accumulated expenditures for the asset during the period. The capitalization rates used in an accounting period shall be based on the rates applicable to borrowings outstanding during the period. If an entity's financing plans associate a specific new borrowing with a qualifying asset, the entity may use the rate on that borrowing as the capitalization rate to be applied to that portion of the average accumulated expenditures for the asset that does not exceed the amount of that borrowing. If average accumulated expenditures for the asset exceed the amounts of specific new borrowings associated with the asset, the capitalization rate to be applied to such excess shall be a weighted average of the rates applicable to other borrowings of the entity.
ASC 835-20 requires debtors to capitalize certain interest costs as part of the cost of “qualifying assets.” Generally, capitalization of interest is required during the period that an entity is getting a qualifying asset ready for its intended use. Qualifying assets include assets that are (1) constructed or produced either for the entity’s own use or, as discrete projects, for lease or sale (e.g., ships or real estate) or (2) accounted for under the equity method “while the investee has activities in progress necessary to commence its planned principal operations.” Capitalization is not permitted for assets that are in use, substantially complete and ready for their intended use, or not in use unless they are undergoing activities necessary to get them ready for use. Further, capitalization is not permitted for inventories that are produced in large quantities on a repetitive basis.

An entity determines the amount to be capitalized by applying a capitalization rate to the average amount of accumulated expenditure it has incurred on a qualifying asset during a period. To the extent that the average accumulated expenditures do not exceed the amount of specific new borrowings related to a qualifying asset, the entity is permitted to use the rate on those borrowings as the capitalization rate. Otherwise the entity uses a weighted average rate applicable to borrowings outstanding during the period. In determining an appropriate capitalization rate, the entity should also consider the amortization of any fair value hedge adjustments on its outstanding borrowings (see ASC 815-25-35-14).

14.2.5 Reference Rate Reform

14.2.5.1 Background

In March 2020, the FASB issued ASU 2020-04, which adds ASC 848 to U.S. GAAP. ASC 848 permits entities to elect optional expedients and exceptions related to the application of certain accounting requirements for contracts, hedging relationships, and other transactions that refer to a reference rate that is expected to be discontinued as a result of the anticipated transition away from the use of interbank offered rates (e.g., LIBOR) to alternative reference rates. An entity can elect to apply the optional expedients and exceptions to certain contract modifications and hedging relationships from the beginning of the interim period that includes March 20, 2020, through December 31, 2022. While a comprehensive discussion of ASC 848 is beyond the scope of this Roadmap, this section briefly discusses the guidance in ASC 848-20 on contract modifications (see Section 14.2.5.2) and summarizes the relief available to debtors under ASC 470-50 and ASC 815-15 for such modifications (see Sections 14.2.5.3 and 14.2.5.4, respectively). For a detailed discussion of this and other optional relief available under ASC 848, including relief related to hedging relationships involving debt, see Deloitte’s March 23, 2020, Heads Up. Note that as part of the FASB’s monitoring of global reference rate reform activities, the Board issued a proposed ASU in October 2020 that would refine the scope of ASC 848 and clarify some of its guidance. For more information about the proposal, see Deloitte’s November 6, 2020, Heads Up.
14.2.5.2 Scope

ASC 848-20 permits an entity to elect certain expedients (such as those described in Sections 14.2.5.3 and 14.2.5.4) related to the modification of contract terms that will directly replace, or have the potential to replace, an affected rate with another interest rate index, as well as certain contemporaneous modifications of other contract terms related to the replacement of an affected rate. When contemporaneous modifications are made, an entity’s eligibility to use the optional expedients depends on whether the contemporaneous modifications to the other terms (1) could affect the amount or timing of contractual cash flows and (2) are related to reference rate reform. If a contemporaneous contract modification could affect the amount or timing of contractual cash flows, the optional expedients are not available if that modification is unrelated to the replacement of a reference rate. Changes in contract terms are considered unrelated to the replacement of a reference rate if they are “the result of a business decision that is separate from or in addition to changes to the terms of a contract to effect that transition.” If it is not possible for a contemporaneous contract modification to affect the amount or timing of contractual cash flows, an entity is not precluded from applying the optional expedients even if that modification is unrelated to the replacement of a reference rate.
The following table provides examples of possible types of modifications and indicates whether they generally would be considered related to the replacement of a reference rate:

<table>
<thead>
<tr>
<th>Related</th>
<th>Unrelated</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Changes to:</strong></td>
<td><strong>Changes to:</strong></td>
</tr>
<tr>
<td>- The referenced interest rate index (e.g., from LIBOR to another interest rate index)</td>
<td>- The notional amount</td>
</tr>
<tr>
<td>- The reset period, reset dates, day-count or business-day conventions, payment dates or frequency, or the repricing calculation</td>
<td>- The maturity date</td>
</tr>
<tr>
<td>- The strike price of an existing interest rate option (including an embedded interest rate option)</td>
<td>- The stated rate from a referenced interest rate index to a fixed rate (except for the last published rate of an interest rate index that is discontinued)</td>
</tr>
<tr>
<td>- The terms necessary to comply with laws or regulations or to align with market conventions for the replacement rate</td>
<td>- The loan structure (e.g., changing a term loan to a revolver loan)</td>
</tr>
<tr>
<td>- The terms necessary to comply with laws or regulations or to align with market conventions for the replacement rate</td>
<td>- The counterparty (except as already permitted by specified sections of ASC 815)</td>
</tr>
<tr>
<td>- The priority or seniority of an obligation in the event of a default or liquidation</td>
<td>- The priority or seniority of an obligation in the event of a default or liquidation</td>
</tr>
<tr>
<td><strong>The addition of:</strong></td>
<td><strong>The addition of:</strong></td>
</tr>
<tr>
<td>- An out-of-the-money interest rate floor or cap</td>
<td>- An in-the-money interest rate floor or cap</td>
</tr>
<tr>
<td>- A prepayment option whose exercise is contingent on the inability of the replacement reference interest rate index to be determinable on the basis of the agreement’s terms</td>
<td>- An underlying or variable not related to the referenced interest rate index (e.g., payments indexed to gold prices)</td>
</tr>
<tr>
<td><strong>The addition of or changes to:</strong></td>
<td><strong>The addition or removal of:</strong></td>
</tr>
<tr>
<td>- A spread adjustment for the difference between an existing reference rate and the replacement reference rate</td>
<td>- A prepayment option (except for the addition of a prepayment option that is contingent on the replacement reference interest rate index not being determinable)</td>
</tr>
<tr>
<td>- Contractual fallback terms if such changes are consistent with fallback terms recommended by a regulator or a private-sector working group convened by a regulator</td>
<td>- A conversion option</td>
</tr>
<tr>
<td>- The right to use one or more underlying assets in a lease contract</td>
<td>- A leverage feature</td>
</tr>
<tr>
<td>- A concession granted to a debtor experiencing financial difficulty</td>
<td></td>
</tr>
</tbody>
</table>

Further, ASC 848-20 permits an entity to disregard circumstances in which modified fallback terms include or have the potential to include a term unrelated to reference rate reform if, when the fallback terms are added or amended, the entity “determines that activation of the term unrelated to reference rate reform is not probable of occurring if the fallback terms are triggered.”
### 14.2.5.3 Evaluation of Debt Modifications Under ASC 470-50

**ASC 848-20**

35-8 If an entity elects the optional expedient in this paragraph, the entity shall account for a modification of a contract within the scope of Topic 470 that meets the scope of paragraphs 470-50-40-14, 470-50-40-16, 470-50-40-17(b), and 470-50-40-18(b) as if the modification was not substantial. That is, the original contract and the new contract shall be accounted for as if they were not substantially different from one another, and the modification shall not be accounted for in the same manner as a debt extinguishment in accordance with paragraph 470-50-40-13.

35-9 If the optional expedient in paragraph 848-20-35-8 is elected, it shall be applied to all contracts under Topic 470 as described in paragraph 848-20-35-1.

35-10 If the optional expedient in paragraph 848-20-35-8 is elected, an entity that applies the 10 percent cash flow test described in paragraph 470-50-40-10 for any subsequent contract modification within a year shall consider only terms and provisions that were in effect immediately following the election of the optional expedient for the particular contract.

If a debt modification is within the scope of the elective relief (see Section 14.2.5.2), the debtor can choose to account for the modification as if it was not substantial under ASC 470-50 even if the modification would have been considered an extinguishment under ASC 470-50 (see Section 10.3). When elected, the optional expedient must be applied consistently for all eligible contracts within the scope of ASC 470. In performing the 10 percent cash flow test (see Section 10.3.3) in ASC 470-50-40-10 for any subsequent contract modifications made within a year, the debtor should consider only terms and provisions that were in effect immediately following the election of the optional expedient, which is an exception to the guidance in ASC 470-10-25-12(f) (see Section 10.3.3.4).

### 14.2.5.4 Reassessment of Embedded Derivatives Under ASC 815-15

**ASC 848-20**

35-14 If the optional expedient in this paragraph is elected, modification of a contract that meets the scope of paragraphs 848-20-15-2 through 15-3 (including the addition of an interest rate floor or cap that is out of the money in paragraph 848-20-15-5(e)) shall not require an entity to reassess its original conclusion about whether that contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract for the purposes of paragraph 815-15-25-1(a).

35-15 If the optional expedient in paragraph 848-20-35-14 is elected, it shall be applied to all contracts under Subtopic 815-15 as described in paragraph 848-20-35-1.

If a debt modification is within the scope of ASC 848 (see Section 14.2.5.2), the debtor can elect not to reassess its conclusion about whether the debt contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract under ASC 815-15 (see Section 8.5.4). When elected, the optional expedient must be applied consistently for all eligible contracts within the scope of ASC 815-15.
14.3 Balance Sheet Presentation

14.3.1 Balance Sheet

14.3.1.1 Balance Sheet Offseting

<table>
<thead>
<tr>
<th>ASC 210-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-1 A right of setoff exists when all of the following conditions are met:</td>
</tr>
<tr>
<td>a. Each of two parties owes the other determinable amounts.</td>
</tr>
<tr>
<td>b. The reporting party has the right to set off the amount owed with the amount owed by the other party.</td>
</tr>
<tr>
<td>c. The reporting party intends to set off.</td>
</tr>
<tr>
<td>d. The right of setoff is enforceable at law.</td>
</tr>
<tr>
<td>45-2 A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.</td>
</tr>
</tbody>
</table>

When certain conditions are met, ASC 210-20 permits but does not require an entity to offset the carrying amounts of assets and liabilities and present only a net amount on the balance sheet (i.e., only a net asset or a net liability is presented related to the amounts that have been offset). Offsetting does not affect the application of the accounting requirements that apply to the recognition, measurement, and derecognition of assets and liabilities (e.g., it does not affect when gain or loss recognition is appropriate or how it should be measured); it only affects the display of assets and liabilities on the balance sheet.

Under ASC 210-20-45-1, four conditions to be met for an entity to offset assets and liabilities:

1. “Each of two parties owes the other determinable amounts.”
   That is, (1) an entity cannot offset receivables and payables with different counterparties, (2) the amounts must be determinable (i.e., contingent or estimated amounts cannot be offset), and (3) an entity is not precluded from offsetting amounts that are denominated in different currencies or have different stated interest rates (see ASC 210-20-45-3).

2. “The reporting party has the right to set off the amount owed with the amount owed by the other party.”
   In the absence of a right to set off, an entity cannot present amounts net even if it expects that such amounts will be net settled. If the maturities of a payable and receivable with the same counterparty differ, only the party with the nearer maturity can offset the related amounts (see ASC 210-30-45-3). Balances without an explicit settlement date cannot be set off (see ASC 940-405-55-1). For example, payables cannot be offset against cash on deposit at a financial institution (see ASC 210-20-55-18A).

3. “The reporting party intends to set off.”
   An entity should document its intention to set off, and that intention should be consistent with its past practice of setting off in similar situations, if applicable (see ASC 210-20-45-5). If an entity’s right to set off is contingent on the entity’s or the counterparty’s default, the related amounts cannot be presented net. The right to set off must be exercisable in the normal course of business. If an entity does not expect to set off amounts, those amounts do not qualify for net presentation on the balance sheet.
There are two exceptions to this condition. They apply to amounts recognized under certain (1) repurchase agreements and reverse repurchase agreements accounted for as collateral borrowings under ASC 860 (see ASC 210-20-45-11 through 45-17) and (2) derivatives and cash collateral balances subject to a master netting agreement (see ASC 815-10-45-7). However, these exceptions do not apply to debt that is within the scope of the guidance in this Roadmap (see Section 2.3.2).

4. “The right of setoff is enforceable at law.”

A legal analysis may be necessary in the determination of whether an enforceable right of setoff exists. In accordance with ASC 210-20-45-9, all available evidence must be considered and must provide “reasonable assurance that the right of setoff would be upheld in bankruptcy.” An entity cannot necessarily assume that it has a right to set off even if a contract states so, since state laws differ and the U.S. bankruptcy code limits the ability to assert a right of set off in certain circumstances (see ASC 210-20-45-8).

An entity should apply a consistent policy for offsetting amounts that qualify for such treatment.

### 14.3.1.2 Legal-Form Debt Cannot Be Presented in Equity

**SEC Staff Accounting Bulletins**

<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Facts:</strong> Company E proposes to include in its registration statement a balance sheet showing its subordinate debt as a portion of stockholders’ equity.</td>
</tr>
<tr>
<td><strong>Question:</strong> Is this presentation appropriate?</td>
</tr>
<tr>
<td><strong>Interpretive Response:</strong> Subordinated debt may not be included in the stockholders’ equity section of the balance sheet. Any presentation describing such debt as a component of stockholders’ equity must be eliminated. Furthermore, any caption representing the combination of stockholders’ equity and only subordinated debts must be deleted.</td>
</tr>
</tbody>
</table>

An instrument that represents a legal-form debt obligation should be presented as a liability even if it has certain economic characteristics that are similar to those of an equity instrument. For example, debt that has a stated maturity, a stated coupon right, and creditor rights (e.g., an ability to seek recourse in a bankruptcy court) is presented as a liability on the basis of its legal form even if it is mandatorily convertible into the debtor’s equity shares. As noted in SAB Topic 4.A, a debtor is not permitted to present debt as a component of equity even if it is subordinated to other debt or presented in a balance sheet caption that includes both subordinated debt and equity.

An instrument that represents a legal-form debt obligation in the jurisdiction in which it is issued and carries creditor rights should be presented as a liability even if the issuer only has a de minimis amount of common equity capital and the instrument (1) is described as an “equity certificate,” (2) has a long maturity (e.g., 40 years) or no stated maturity, (3) is subordinated to all other creditors, (4) contains conversion rights into common equity, and (5) provides dividend rights that are similar to those of a holder of common equity (e.g., payable only if declared). If it is not readily apparent whether a claim on the entity legally represents debt or equity, the entity may need to seek an opinion from legal counsel.

A debtor is precluded from presenting debt as equity even if it is converted into the debtors’ equity shares or repaid from the proceeds of the issuance of equity-classified shares shortly after the balance sheet date. Such an event represents a nonrecognized subsequent event under ASC 855. Further, ASC 470-10-45-14(a) states that if “equity securities have been issued for the purpose of refinancing a short-term obligation on a long-term basis . . . the short-term obligation, although excluded from current liabilities, shall not be included in owners’ equity” (see Section 13.7.3).
14.3.1.3 **Structured Trade Payable Arrangements**

**SEC Rules, Regulations, and Interpretations**

**Regulation S-X, Rule 5-02, Balance Sheets [Reproduced in ASC 210-10-S99-1]**

19. Accounts and notes payable.
   (a) State separately amounts payable to
       (1) banks for borrowings;
       (2) factors or other financial institutions for borrowings;
       (3) holders of commercial paper;
       (4) trade creditors;
       (5) related parties (see § 210.4-08(k));
       (6) underwriters, promoters, and employees (other than related parties); and
       (7) others.
   Amounts applicable to (1), (2) and (3) may be stated separately in the balance sheet or in a note thereto.

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When an entity purchases goods or services on credit from a supplier (vendor), a trade payable arises for the invoice amount owed to the supplier. Sometimes entities with trade payables enter into arrangements with a bank or other intermediary under which the intermediary offers to purchase receivables held by the entity's suppliers. Such arrangements are known by various names, such as "structured payable arrangements," "vendor payable programs," "open account structured vendor payable programs," "reverse factoring," "supplier finance," or "supplier-chain finance."

Examples of structured payable arrangements include (1) open account platforms that permit an entity's suppliers to elect to sell trade receivables to one or more participating intermediaries, (2) an entity's use of charge cards issued by a financial institution to settle invoices, and (3) an entity's issuance of negotiable instruments (e.g., bills of exchange) to settle invoices.

Typically, open account platforms give participating suppliers the option to settle trade receivables by obtaining a payment from an intermediary either (1) before the invoice date at a discounted amount or (2) on the invoice due date for its full amount. Although the supplier may receive payment early, the purchasing entity is not required to settle its trade payable with the intermediary until the original invoice date.

Depending on its terms, a structured trade payable arrangement offers the parties various potential benefits, such as the following:

- **Suppliers can monetize trade receivables and reduce the associated credit exposure** — By selling their trade receivables to an intermediary, suppliers can receive payment before the invoice due date and reduce their credit exposure.

- **Purchasers can obtain extended payment terms** — Suppliers may be more willing to agree to extended payment terms with purchasers if they can obtain early payment from intermediaries. Further, intermediaries may offer purchasers extended payment terms.

- **Intermediaries can benefit from early payment discounts, rebates, and transaction fees and charges** — Intermediaries earn a spread on the basis of the relationship between their funding costs and the amount of early payment discounts, rebates, and other fees and charges received from suppliers.
• **Operational benefits** — Because of an intermediary's involvement, the arrangement may enhance the processing, administration, and control of the associated payments for purchasers and suppliers.

• **Extended early-payment discount period** — If an intermediary pays a supplier within the period during which the supplier offers an early payment discount (e.g., a 2 percent discount for payment within 30 days or 2/10 net 30), for instance, the intermediary may offer the entity a discount on the amount due for an extended period (e.g., 1/10 net 60).

• **Reduction in the amount due or other similar rebate** — The intermediary may offer the entity a reduction of the amount due or a reimbursement of part of the amount paid on the basis of net amounts paid to suppliers. (A supplier may agree to pay the intermediary a fee or reduce the amount due because of benefits it receives from the arrangement, such as a lowered credit risk exposure on the amount due or earlier payment of such amount.)

If an entity has a trade payable arrangement involving an intermediary, it should consider how to appropriately present and disclose the amount payable. Regulation S-X, Rule 5-02(19)(a), requires SEC registrants to present amounts payable to trade creditors separately from borrowings on the face of the balance sheet. Accordingly, a purchasing entity that participates in a trade payable program involving an intermediary should consider whether the intermediary's involvement changes the appropriate presentation of the payable from a trade payable to a borrowing from the intermediary (e.g., bank debt). Entities often seek to achieve trade payable classification because trade payables tend to be treated more favorably than short-term indebtedness in the calculation of financial ratios (e.g., balance sheet leverage measures) and in the determination of whether financial covenants are met. Further, the determination of whether the payable should be presented as an amount owed to trade creditors or an amount borrowed from the intermediary may affect the appropriate cash flow statement classification (see below for further discussion).

Generally, a supplier’s decision to factor a trade receivable to a bank or other financial institution does not affect the purchaser’s presentation of the associated trade payable if the factoring terms are negotiated and agreed to independently by the supplier and the institution without any involvement of the purchaser, which may not even be aware of the factoring transaction. Similarly, an entity’s decision to outsource its supplier processing payments to an intermediary does not necessarily cause a reclassification of associated trade payables if the terms of the payables remain unaffected and the entity is not involved in, or does not benefit from, transactions between the suppliers and the intermediary. In other words, if the intermediary’s involvement does not change the nature, amount, and timing of the entity’s payables and does not provide the entity with any direct economic benefit, continued trade payable classification may be appropriate. However, reclassification may be required if such changes or benefits result from the intermediary’s involvement (e.g., because fees or rebate payments were received from the intermediary).

In speeches at the 2003 and 2004 AICPA Conferences on Current SEC and PCAOB Developments, Professional Accounting Fellow Robert Comerford discussed the SEC staff’s views about the presentation of certain trade payable arrangements involving an intermediary as trade payables or short-term borrowings. At the 2004 event, he stated the following:

> As a general rule, the OCA Staff does not believe that it is possible to determine the appropriate accounting for structured transactions simply via reference to checklists and templates. Rather, . . . an entity must perform a thorough analysis of all the facts and circumstances specific to the individual transaction in order to ensure that the entity’s accounting for the transaction serves investors well. . . . [T]his necessitates meeting not just the letter, but the spirit of the accounting literature.
Mr. Comerford identified a number of points (summarized below) that the SEC staff encourages preparers and auditors to consider in determining whether amounts due in trade payable arrangements involving an intermediary should be classified as trade payables or borrowings. He also noted that a registrant may wish to preclear its proposed classification with the OCA if there is a risk that its position could be subject to challenge. Given the subjective nature of the evaluation and the lack of prescriptive guidance, alternative views may be acceptable in some circumstances.

<table>
<thead>
<tr>
<th>SEC Staff Consideration Point</th>
<th>Related SEC Staff Observations</th>
<th>Deloitte Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>What are “the roles, responsibilities and relationships of each party” to the arrangement? What is “the totality of the arrangement”?</td>
<td>By analogy to a supplier’s factoring of accounts receivables, the definition of factoring “does not make any mention of the [purchaser] actively or passively participating in the process.”</td>
<td>It can be helpful to consider whether the intermediary’s role in the arrangement is primarily that of (1) a factor of supplier receivables, (2) a finance provider to the entity, or (3) the entity’s paying agent. If the intermediary’s involvement does not change the nature, amount, and timing of the entity’s payments and does not provide the entity with any direct economic benefit, continued trade payable classification may be appropriate. See below for further discussion.</td>
</tr>
<tr>
<td>“Does the financial institution make any sort of referral or rebate payments” to the purchaser?</td>
<td>By analogy to a supplier’s factoring of accounts receivables, the definition of factoring “does not make any mention of [the supplier’s] customer receiving . . . any referral fees or rebates.”</td>
<td>If the entity receives no fees, rebates, payments, or other direct economic benefits from transactions between suppliers and the intermediary, continued trade payable classification may be appropriate. An entity’s receipt of referral or rebate payments from the intermediary (e.g., on the basis of fees, early settlement discounts collected by the intermediary, or a dollar-volume-based rebate) suggests that continued classification of a payable as an amount owed to trade creditors may no longer be appropriate. In practice, classifying payables as trade payables has been considered unacceptable when the purchaser shares in early settlement discounts collected by the intermediary from the supplier (e.g., the intermediary provides a rebate to the purchaser that is equivalent to half of a 2 percent early settlement discount received from the supplier).</td>
</tr>
<tr>
<td>“Has the financial institution reduced the amount due . . . , such that the amount due is less than the amount the [entity] would have had to pay to the vendor on the original payable due date?”</td>
<td>By analogy to a supplier’s factoring of accounts receivables, the definition of factoring does not “make any mention of the [supplier’s] customer receiving any reductions in the amount of its obligation.”</td>
<td>If the entity’s original invoice terms remain the same, continued trade payable classification may be appropriate. An intermediary’s reduction of the amount due from the entity may suggest that continued classification of a payable as an amount owed to trade creditors is no longer appropriate.</td>
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(Table continued)

<table>
<thead>
<tr>
<th>SEC Staff Consideration Point</th>
<th>Related SEC Staff Observations</th>
<th>Deloitte Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Has the financial institution extended beyond the payable's original due date, the date on which payment is due?&quot;</td>
<td>By analogy to a supplier's factoring of accounts receivables, the definition of factoring does not &quot;make any mention of the [supplier's] customer receiving . . . any extension of its trade payable maturity dates beyond that which were customary prior to the inception of the arrangement [e.g.,] 2/10 net 30.&quot;</td>
<td>Payment terms and amounts that remain consistent with those of the entity's other vendor payables and industry practice may suggest that continued classification as a trade payable may be appropriate. However, if the intermediary is not merely facilitating the payment of the entity's invoice but extending the entity's due date to a date after the original invoice due date and the date the intermediary pays suppliers, the entity's arrangement may, in substance, be a borrowing from the intermediary.</td>
</tr>
<tr>
<td>The literal definition of the term &quot;trade creditor.&quot;</td>
<td>&quot;The OCA Staff believes that a trade creditor is a supplier that has provided an entity with goods and services in advance of payment.&quot;</td>
<td>Generally, third-party factoring arrangements involving an entity's payables do not preclude trade payable classification if the entity has no involvement and is not a party to contracts entered into between the supplier and the factor. If the creditor at origination is a supplier, therefore, the supplier's subsequent sale of its receivable to a factor does not necessarily change the nature of that trade payable so that reclassification is required.</td>
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As noted above, one of the consideration points is related to the roles, responsibilities, and relationships among the parties and the totality of the arrangement, such as whether the intermediary’s primary role in the arrangement is that of a factor of supplier receivables, a finance provider to the purchaser, or a paying agent of the purchaser. In some arrangements, the intermediary may serve both as a paying agent and a factor or finance provider (e.g., if the intermediary gives suppliers the option to either receive payment on the original invoice due date or to transfer trade receivables to the intermediary before the due date at a discounted amount).

<table>
<thead>
<tr>
<th>Primary Role of Intermediary</th>
<th>Description</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factor of trade receivables</td>
<td>The intermediary purchases trade receivables from the entity's suppliers, with no active involvement of the entity. The arrangement does not significantly affect the nature, amount, and timing of the entity's payments to settle trade payables.</td>
<td>Trade payable classification may be appropriate.</td>
</tr>
<tr>
<td>Finance provider to purchasing entity</td>
<td>The entity's purpose is to obtain financing from the intermediary. The arrangement affects the nature, amount, or timing of the entity's payments to settle trade payables, and there may be a direct economic benefit to the entity.</td>
<td>Trade payable classification is likely to be inappropriate.</td>
</tr>
<tr>
<td>Paying agent of purchasing entity</td>
<td>The intermediary acts as the purchasing entity's paying agent in settling trade payables with suppliers on behalf of the entity.</td>
<td>Although trade payable classification may be appropriate initially, the purchasing entity should assess whether extinguishment accounting is required under ASC 405-20 when the intermediary pays the supplier.</td>
</tr>
</tbody>
</table>
In practice, additional factors that an entity may consider in its evaluation of whether amounts due in trade payable arrangements involving an intermediary should be classified as trade payables or borrowings include:

<table>
<thead>
<tr>
<th>Consideration Point</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>How significant is the entity's involvement in the contractual relationship between suppliers and the intermediary?</td>
<td>The purchaser’s involvement in the initial set-up of the process (e.g., by requiring vendors to sign up with the intermediary and submitting invoices for payment to the financial institution (e.g., in an electronic payable processing system) would not necessarily preclude a conclusion that the payable is still an amount due to trade creditors. More direct involvement by the purchasing entity may suggest that trade payable classification is inappropriate, particularly if the entity has a direct economic interest in the terms agreed to between the suppliers and the intermediary (e.g., through the sharing of fees or discounts received by the intermediary from suppliers).</td>
</tr>
<tr>
<td>Have any of the terms of the payable changed as a result of the intermediary's involvement in the arrangement?</td>
<td>If the terms of the payable have not changed as a result of the intermediary's involvement in the arrangement, continued trade payable classification may be appropriate. If the intermediary has rights that go beyond that of a holder of the original trade receivable (e.g., a priority claim in the entity's liquidation), reclassification may be required.</td>
</tr>
<tr>
<td>Does the supplier maintain recourse against the entity?</td>
<td>The supplier's maintenance of recourse against the entity for nonpayment, and the intermediary's recourse against the supplier if the entity does not pay, may help support a conclusion that the payable should be presented as a trade payable.</td>
</tr>
<tr>
<td>Does the entity still have the right to negotiate returns of damaged goods and refunds and other adjustments to the invoice terms with the supplier?</td>
<td>If the entity does not retain the right to negotiate returns of damaged goods and refunds and other adjustments to the invoice terms with the supplier (e.g., in case of commercial disputes), reclassification may be required.</td>
</tr>
<tr>
<td>Is supplier participation voluntary?</td>
<td>Although a requirement for an entity's suppliers to participate in a trade payable arrangement with an intermediary is not determinative, it may support a conclusion that trade payable classification is inappropriate.</td>
</tr>
<tr>
<td>Is the arrangement offered to a broad range of suppliers?</td>
<td>If the arrangement is offered only to one or a small, limited group of suppliers, a conclusion that trade payable classification is inappropriate may be supported.</td>
</tr>
<tr>
<td>Are the payment terms consistent with those of trade payables in the entity's industry?</td>
<td>If the payment terms are atypical of those of trade payables in the entity's industry (e.g., due dates) because of the intermediary's involvement in the arrangement, trade payable classification may be inappropriate.</td>
</tr>
<tr>
<td>Is the entity informed of transactions between suppliers and the intermediary?</td>
<td>The entity's lack of direct knowledge of transactions between suppliers and the intermediary (e.g., early settlements at a discount) may help support a conclusion that the payable should be presented as a trade payable. However, the entity's right to obtain such information does not necessarily preclude trade payable classification.</td>
</tr>
<tr>
<td>Does interest accrue before the due date?</td>
<td>The fact that the payable accrues interest before the due date may suggest that trade payable classification is inappropriate.</td>
</tr>
<tr>
<td>What is the legal form of the entity's obligation?</td>
<td>An instrument whose legal form under the U.S. Uniform Commercial Code is more like a negotiable instrument (such as a promissory note) than an account payable may suggest that trade payable classification is inappropriate. (The intermediary may prefer the legal form to be that of a negotiable instrument to facilitate transfers of the receivable.)</td>
</tr>
</tbody>
</table>
In his 2003 speech, Mr. Comerford provided two examples of arrangements involving trade payable transactions with an intermediary that an entity should not, according to the SEC staff, present as amounts payable to trade creditors but rather as borrowings from financial institutions:

- “[A]n intermediary, typically a financial institution or one of its affiliates, pays trade payables on behalf of the purchaser in order to take advantage of discounts for early payment that the purchaser would not otherwise avail itself of. The purchaser then pays the lender either the full amount of the trade payable at a future date beyond the payable's normal terms, or an amount less than the full amount of the trade payable but on the trade payable's normal due date. Thus, the arrangement between the lender and the purchaser often results in the purchaser securing financing at lower cost of funds than is inherent in the vendor's invoice. In this transaction, the vendor is often not aware of the arrangement between the purchaser and the lender.”

- “[T]he vendor [is] a willing participant in a tri-party arrangement between the manufacturer, the vendor and the intermediary. Specifically, the intermediary accepts an IOU from the purchaser and presents a separate IOU to the vendor. The lender provides the purchaser with incentives similar to those provided in the first transaction and provides the vendor with the ability to present its IOU to the lender for accelerated payment at an appropriately discounted amount.”

In both examples, the purchasing entity benefits by either (1) obtaining a repayment date from the financial institution beyond the due date of the original payable or (2) sharing in a portion of the trade discount received by the financial institution via the accelerated payment to the vendor. Further, the payments made by the intermediary to the vendor “were made within the time period necessary to secure a trade discount.” Mr. Comerford noted that the OCA objects to trade payable classification in these circumstances. Instead, the staff believes as follows:

> [T]he substance of both of these transactions equates to the purchaser obtaining financing from a lender in order to pay amounts due to its vendors. . . . [T]he manufacturer's original liability to the vendor is extinguished on the date the lender remits cash or a lender IOU to the vendor. Pursuant to the provisions of Article 5, the purchaser should derecognize its trade account payable and record a new liability classified on its balance sheet as a borrowing from the lender. Consistent with this classification, the purchaser should then accrete the difference between the initial carrying amount of the borrowing (i.e. the discounted amount of the vendor invoice) and the repayment amount (i.e. the amount owed to the lender) through interest expense using the effective yield method.

In his 2004 speech, Mr. Comerford warned registrants and auditors not to mistake the SEC staff’s 2003 discussion of the two trade payable arrangements for a set of rules to use for determining when short-term borrowings should be classified as trade payables. Rather, as noted above, an entity must consider all the facts and circumstances and comply with both the letter and the spirit of the accounting requirements.
We are not aware that the SEC staff has addressed an entity's use of p-cards (i.e., purchase cards), other types of charge cards, or credit cards to pay invoices. If these arrangements are only used as the original mechanism to incur an expenditure with a vendor, it may be acceptable to consider such amounts owed as trade payables in certain situations. For example, if one of these types of bank-issued cards is used only as a matter of convenience to incur an expenditure (i.e., pay the vendor immediately), the amounts owed are paid during the customary period in which trade payables are due, and interest costs are not incurred, classification of such amounts owed as trade payables is generally acceptable.

P-cards and other charge cards are sometimes used by entities to extend payment terms. When a p-card or other charge card is used to pay an invoice owed to a vendor, the entity has extinguished its liability to the vendor and incurred an obligation with a bank. Therefore, continued classification as a trade payable is not appropriate. For example, an entity might extend the payment terms on a trade payable with an invoice due date of April 1, 20X0, by using a charge card that has a monthly settlement date of April 30, 20X0, for which full payment of all charges incurred in April 20X0 are due on May 31, 20X0. In this scenario, the entity has extended the payment terms by 60 days. Continued classification as a trade payable after the vendor has been paid is inappropriate; therefore, such classification could only be accepted on the basis of a materiality argument in this type of arrangement.

It is difficult to distinguish between (1) an entity's use of a credit card to make payments to vendors and (2) its use of a traditional revolving line of credit to make such payments (i.e., in both arrangements, interest costs accrue). Therefore, any time a credit card is used to pay trade payables, the entity should reclassify such payables as liabilities owed to a bank. In no situation in which an entity (1) uses any type of bank-issued card to pay invoices and (2) incurs interest on such card can the entity continue to classify as trade payables amounts paid to vendors as a result of having incurred those charges.

**Example 14-1**

**Structured Vendor Payable Program**

A structured vendor payable program (SVPP) that is established as follows might not change the characteristics of trade payables (i.e., it might not require reclassification to short-term debt):

- The entity enters into an agreement for buyer payment services in which the intermediary is acting as the entity's paying agent for the entity's suppliers.
- The intermediary offers participating suppliers the opportunity to voluntarily factor their receivables from the entity to the intermediary. That is, a supplier is able to factor its receivable to the intermediary on a discounted basis before the invoice due date. Specifically, the intermediary offers vendors the following two payment options: (1) payment on the due date in 60 days or (2) advance payment in 30 days at a 2.5 percent discount.
- The SVPP does not relieve the entity of its obligation to its suppliers under invoices eligible for factoring under the SVPP. The supplier maintains recourse against the entity for nonpayment and for any commercial dispute related to the invoice.
- The SVPP does not change the payment terms, timing, or amount with respect to the entity's obligation to its supplier. The entity's obligation to the supplier is neither affected nor reduced by any separate contract between the intermediary and the supplier.
- The payment terms are consistent with those typically offered in the entity's industry.
- The entity will not participate in any negotiations between suppliers and the intermediary.
- Although the entity may request such information from the intermediary, it will not be automatically notified of any advance payment or other transactions between the supplier and intermediary.
- The entity is not obligated to pay any fees directly to the intermediary and will not receive any amounts or benefits from the intermediary in the form of a rebate or other incentives. The entity is obligated to pay the full invoice amount even if the intermediary paid the supplier at a discount.
- The legal form of the trade payable has not changed.
On the basis of our discussions with the SEC staff in the context of registrant preclearance processes, we understand that the staff expects an issuer to consider disclosing the following information, if material, related to trade payable arrangements involving an intermediary:

- A description of the arrangement and why the entity entered into the arrangement.
- A description of the benefits to the entity and to the entity’s suppliers.
- The amount that is eligible for factoring and the amount that has been factored (if known).
- Any risks the arrangement exposes the entity to and how those risks are mitigated.

In recent comment letters to registrants, the SEC staff has expressed interest in better understanding the quantitative and qualitative characteristics of such arrangements, such as:

- The dollar amounts settled under the arrangement and the balance representative of amounts owed to the financial institution or intermediary.
- The analysis supporting classification of amounts settled under the arrangement as trade payables or bank financing, including classification and noncash disclosure considerations required by ASC 230.
- The arrangement’s impact on an entity’s payment terms to its suppliers, days payable outstanding, liquidity, and risk factors.

If a trade payable arrangement involving an intermediary must be classified as a borrowing, the entity should consider the associated cash flow statement implications (see also Section 7.2 of Deloitte’s A Roadmap to the Preparation of the Statement of Cash Flows). At the December 2005 AICPA Conference on Current SEC and PCAOB Developments, SEC Associate Chief Accountant Joel Levine stated, in part:

The situation addressed by the staff dealt with a transaction similar to the purchase of non-[X] products financed through [X]. For example, say a dealer purchases [Y and Z] financed under a floor-plan arrangement with [X]. [X] pays the supplier directly and then is repaid later by the dealer. In this case, the financing arrangement is not with the supplier, as it was when the dealer purchased [X] products; therefore, it does not represent a trade loan. It represents a third-party financing arrangement. Not a big deal, except that the inventory purchase, an operating activity, has taken place without the dealer physically delivering the cash. Based on the view that the financing entity effectively has acted as the dealer’s agent, we concluded that upon purchase of the inventory, the dealer should report the increase in the third-party loan in substance as a financing cash inflow, with a corresponding operating cash outflow for the increase in inventory. Upon repayment, the cash outflow would be reported as a financing activity. Here, the cash flows statement would depict the substance of the transactions — with the end result being similar to the previous example where the net effect on operating cash flows is the amount of gross profit generated.

In accordance with this speech, when a trade payable is extinguished and the debt owed to a bank is recognized, the reclassified amount must be treated as an operating cash outflow and a financing cash inflow even though the entity actually did not have any cash outflow. This is because an entity must apply, in substance, a “constructive cash payment/receipt” approach to the transaction when preparing the statement of cash flows. The subsequent cash paid to satisfy the amount owed to the bank is classified as a financing cash outflow.
### 14.3.1.4 Separate Presentation of Debt Measured at Fair Value

#### ASC 825-10

**45-1A** An entity shall separately present financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) in the statement of financial position or the accompanying notes to the financial statements.

**45-1B** Entities shall report assets and liabilities that are measured at fair value pursuant to the fair value option in this Subtopic in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute.

**45-2** To accomplish that, an entity shall either:

a. Present the aggregate of fair value and non-fair-value amounts in the same line item in the statement of financial position and parenthetically disclose the amount measured at fair value included in the aggregate amount

b. Present two separate line items to display the fair value and non-fair-value carrying amounts.

#### ASC 815-15

**45-1** In each statement of financial position presented, an entity shall report hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 815-15-30-1 in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity may do either of the following:

a. Display separate line items for the fair value and non-fair-value carrying amounts

b. Present the aggregate of the fair value and non-fair-value amounts and parenthetically disclose the amount of fair value included in the aggregate amount.

An entity must disaggregate financial liabilities by measurement category either on the face of the balance sheet or in the notes to the financial statements. A debtor that has measured debt instruments at fair value under ASC 825-10 (see Section 4.4) or ASC 815-15 (including those measured at fair value because the entity is unable to reliably identify and measure an embedded derivative that would otherwise need to be bifurcated; see Sections 8.5.5 and 8.5.6) must present those debt instruments on the balance sheet in a manner that separates them from the carrying amounts of similar debt instruments that are measured by using an attribute other than fair value (e.g., debt that is accounted for by using the interest method in ASC 835-30; see Section 6.2). ASC 825 and ASC 815-15 identify two ways to accomplish such presentation: (1) separate line items or (2) parenthetical disclosure of fair value amounts.

In the absence of regulations that require separate presentation of accrued interest, the fair value amount presented on the balance sheet for an interest-bearing financial asset or financial liability accounted for at fair value through earnings should include any interest earned or incurred but not paid (accrued interest). It would, however, be acceptable for an entity to parenthetically disclose the amount of the fair value measurement that represents accrued interest in the financial statement line item for which the interest-bearing financial asset or financial liability accounted for under the fair value option is presented.
If there are regulations that require presentation of accrued interest separately from the related interest-bearing financial asset or financial liability for which the fair value option has been elected, an entity must do one of the following to comply with the disclosure requirements in ASC 825:

- Present the aggregate amount of accrued interest, which represents part of the fair value of the asset or liability, in a separate line item in the statement of financial position.
- Parenthetically disclose the amount of the fair value measurement that represents accrued interest in the financial statement line item for which the interest-bearing financial asset or financial liability is presented.

14.3.1.5 SEC Requirements

The FASB has not prescribed which specific line items an entity must present related to debt on its balance sheet, although debtors typically present short-term borrowings separately from long-term debt (see Chapter 13). Entities that file financial statements with the SEC must comply with the balance sheet requirements in Regulation S-X, including those that apply to the following types of entities:

- Commercial and industrial companies (see Section 14.3.1.5.1 below).
- Bank holding companies (see Section 14.3.1.5.2).
- Insurance companies (see Section 14.3.1.5.3).
- Registered investment companies (see Section 14.3.1.5.4).

14.3.1.5.1 Commercial and Industrial Companies

SEC Rules, Regulations, and Interpretations

Regulation S-X, Rule 5-02, Balance Sheets [Reproduced in ASC 210-10-S99-1]

The purpose of this rule is to indicate the various line items and certain additional disclosures which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the balance sheets or related notes filed for the persons to whom this article pertains (see § 210.4-01(a)). . . .

Liabilities and Stockholders' Equity

Current Liabilities, When Appropriate

19. Accounts and notes payable.

(a) State separately amounts payable to

1. banks for borrowings;
2. factors or other financial institutions for borrowings;
3. holders of commercial paper;
4. trade creditors;
5. related parties (see § 210.4-08(k));
6. underwriters, promoters, and employees (other than related parties); and
7. others.

Amounts applicable to (1), (2) and (3) may be stated separately in the balance sheet or in a note thereto.

(b) The amount and terms (including commitment fees and the conditions under which lines may be withdrawn) of unused lines of credit for short-term financing shall be disclosed, if significant, in the notes to the financial statements. The weighted average interest rate on short term borrowings outstanding as of the date of each balance sheet presented shall be furnished in a note. The amount of these lines of credit which support a commercial paper borrowing arrangement or similar arrangements shall be separately identified.
SEC Rules, Regulations, and Interpretations (continued)

20. Other current liabilities. State separately, in the balance sheet or in a note thereto, any item in excess of 5 percent of total current liabilities. Such items may include, but are not limited to, accrued payrolls, accrued interest, taxes, indicating the current portion of deferred income taxes, and the current portion of long-term debt. Remaining items may be shown in one amount.

21. Total current liabilities, when appropriate.

Long-Term Debt.

22. Bonds, mortgages and other long-term debt, including capitalized leases.
   (a) State separately, in the balance sheet or in a note thereto, each issue or type of 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. For amounts owed to related parties, see § 210.4-08(k).
   (b) The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of unused commitments for long-term financing arrangements that would be disclosed under this rule if used shall be disclosed in the notes to the financial statements if significant.

23. Indebtedness to related parties — noncurrent. Include under this caption indebtedness to related parties as required under § 210.4-08(k). . . .

Regulation S-X requires SEC registrants subject to Rule 5-02 (i.e., commercial and industrial companies) to present current liabilities separately from long-term debt on the face of the balance sheet. When appropriate, a total of current liabilities must also be shown.

Within current liabilities, accounts and notes payable are presented separately from other current liabilities on the face of the balance sheet. Within accounts and notes payable, the amounts of borrowings from (1) banks, (2) factors and other financial institutions, and (3) commercial paper holders are shown separately either on the face of the balance sheet or in the notes. Further, amounts due to (1) trade creditors (e.g., payables for goods or services); (2) related parties; (3) underwriters, promoters, and employees (other than related parties); and (4) others are stated separately on the face of the balance sheet. Other current liabilities include, for example, accrued interest and the current portion of long-term debt. Any item within the other current liabilities category in excess of 5 percent of total current liabilities must be displayed separately on the face of the balance sheet or in the notes.

Within noncurrent liabilities, bonds, mortgages, and other long-term debt, are shown separately from related-party debt. For each issue or type of obligation of bonds, mortgages, and other long-term debt, the entity states separately either on the face of the balance sheet or in a note (1) the general character of each debt type; (2) the interest rate; (3) the maturity date or, for serial-maturity debt (e.g., amortizing debt), the serial maturity period; (4) an indication of any contingency associated with the payment of principal or interest (e.g., additional interest contingent upon an event of default or delayed filings); (5) priority (e.g., senior or subordinated debt); and (6) if applicable, conversion terms.
14.3.1.5.2 Bank Holding Companies

**SEC Rules, Regulations, and Interpretations**

**Regulation S-X, Rule 9-03, Balance Sheets [Reproduced in ASC 942-210-S99-1]**

The purpose of this rule is to indicate the various items which, if applicable, should appear on the face of the balance sheet or in the notes thereto.

13. Short-term borrowing. Disclosure separately on the balance sheet or in a note, amounts payable for

   (1) Federal funds purchased and securities sold under agreements to repurchase;
   (2) commercial paper, and
   (3) other short-term borrowings.

   (a) Disclose any unused lines of credit for short-term financing: (§ 210.5-02.19(b)).

16. Long-term debt. Disclose in a note the information required by § 210.5-02.22.

Regulation S-X requires SEC registrants subject to Rule 9-03 (i.e., bank holding companies) to present separate balance sheet captions for short-term borrowings and long-term debt. However, such entities are not required to present a classified balance sheet with separate subtotals for short-term and long-term liabilities.

Within the short-term borrowings category, entities separately disclose federal funds purchased and securities sold under repurchase agreements, commercial paper, and other short-term borrowing either on the face of the balance sheet or in the notes. For each issue or type of obligation of bonds, mortgages, and other long-term debt, the entity states in a note (1) the general character of each debt type; (2) the interest rate; (3) the maturity date or, for serial-maturity debt (e.g., amortizing debt), the serial maturity period; (4) an indication of any contingency associated with the payment of principal or interest (e.g., additional interest contingent on an event of default or delayed filings); (5) priority (e.g., senior or subordinated debt); and (6) if applicable, conversion terms.

14.3.1.5.3 Insurance Companies

**SEC Rules, Regulations, and Interpretations**

**Regulation S-X, Rule 7-03, Balance Sheets [Reproduced in ASC 944-210-S99-1]**

(a) The purpose of this rule is to indicate the various items which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the balance sheet and in the notes thereto filed for persons to whom this article pertains. (See § 210.4-01(a)).

16. Notes payable, bonds, mortgages and similar obligations, including capitalized leases.

   (a) State separately in the balance sheet the amounts of (1) short-term debt and (2) long-term debt including capitalized leases.

   (b) The disclosure required by § 210.5-02.19(b) shall be given if the aggregate of short-term borrowings from banks, factors and other financial institutions and commercial paper issued exceeds five percent of total liabilities.

   (c) The disclosure requirements of § 210.5-02.22 shall be followed for long-term debt.

17. Indebtedness to related parties. (See § 210.4-0.8(k)).
Regulation S-X requires SEC registrants subject to Rule 7-03 (i.e., insurance companies) to divide their presentation of amounts for notes payable, bonds, mortgages, and similar obligations between short-term debt and long-term debt (including capitalized leases) on the face of the balance sheet. However, such entities are not required to present a classified balance sheet with separate subtotals for short-term and long-term liabilities.

For each issue or type of obligation of long-term debt, the entity discloses separately either on the face of the balance sheet or in a note (1) the general character of each debt type; (2) the interest rate; (3) the maturity date or, for serial-maturity debt (e.g., amortizing debt), the serial maturity period; (4) an indication of any contingency associated with the payment of principal or interest (e.g., additional interest contingent on an event of default or delayed filings); (5) priority (e.g., senior or subordinated debt); and (6) if applicable, conversion terms.

### 14.3.1.5.4 Registered Investment Companies

#### SEC Rules, Regulations, and Interpretations

**Regulation S-X, Rule 6-04, Balance Sheets [Reproduced in ASC 946-210-S99-1]**

This section is applicable to balance sheets filed by registered investment companies and business development companies except for persons who substitute a statement of net assets in accordance with the requirements specified in § 210.6-05, and issuers of face-amount certificates which are subject to the special provisions of § 210.6-06. Balance sheets filed under this rule shall comply with the following provisions: . . .

13. Notes payable, bonds and similar debt.

   (a) State separately amounts payable to:
      1. Banks or other financial institutions for borrowings;
      2. controlled companies;
      3. other affiliates; and
      4. others, showing for each category amounts payable within one year and amounts payable after one year.

   (b) Provide in a note the information required under § 210.5-02.19(b) regarding unused lines of credit for short-term financing and § 210.5-02.22(b) regarding unused commitments for long-term financing arrangements. . . .

Regulation S-X requires SEC registrants subject to Rule 6-04 (i.e., registered investment companies) to present the amount of notes payable, bonds, and similar debt on the face of the balance sheet with a breakdown of amounts payable to (1) banks or other financial institutions for borrowings; (2) controlled companies, (3) other affiliates, and (4) others. For each category, amounts payable within one year and amounts payable after one year are shown. However, such entities are not required to present a classified balance sheet with separate subtotals for short-term and long-term liabilities.
14.3.2 Cash Flow Statement

<table>
<thead>
<tr>
<th>ASC 230-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-14</strong> All of the following are cash inflows from financing activities: . . .</td>
</tr>
<tr>
<td>b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing . . .</td>
</tr>
</tbody>
</table>

|  |
| **45-15** All of the following are cash outflows for financing activities: . . . |
| b. Repayments of amounts borrowed, including the portion of the repayments made to settle zero-coupon debt instruments that is attributable to the principal or the portion of the repayments made to settle other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing that is attributable to the principal. |
| c. Other principal payments to creditors who have extended long-term credit. See paragraph 230-10-45-13(c), which indicates that most principal payments on seller-financed debt directly related to a purchase of property, plant, and equipment or other productive assets are financing cash outflows. . . . |
| e. Payments for debt issue costs. . . . |
| g. Payments for debt prepayment or debt extinguishment costs, including third-party costs, premiums paid, and other fees paid to lenders that are directly related to the debt prepayment or debt extinguishment, excluding accrued interest. |

|  |
| **45-17** All of the following are cash outflows for operating activities: |
| a. Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods. The term goods includes certain loans and other debt and equity instruments of other entities that are acquired specifically for resale, as discussed in paragraph 230-10-45-21. . . . |
| d. Cash payments to lenders and other creditors for interest, including the portion of the payments made to settle zero-coupon debt instruments that is attributable to accreted interest related to the debt discount or the portion of the payments made to settle other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing that is attributable to accreted interest related to the debt discount. For all other debt instruments, an issuer shall not bifurcate cash payments to lenders and other creditors at settlement for amounts attributable to accreted interest related to the debt discount, nor classify such amounts as cash outflows for operating activities. . . . |

Under ASC 230, proceeds from borrowings are classified as cash inflows from financing activities, whereas repayment of amounts borrowed, payments for debt issue costs, and payments for debt prepayment or debt extinguishment costs are classified as cash outflow for financing activities. However, principal payments on notes payable to suppliers for materials or goods are classified as cash outflows for operating activities.

Although ASC 230 does not address debt modifications accounted for under ASC 470-50, when debt is restructured and is accounted for as a modification rather than as an extinguishment, an entity should apply the principles in ASC 230 and classify fees paid to the creditor on the modification date as a financing cash outflow (see Section 6.2.1 of Deloitte’s A Roadmap to the Preparation of the Statement of Cash Flows). Further, any fees paid to a third party other than the creditor in connection with a debt modification should generally be classified as operating cash outflows because, in accordance with ASC 470-50-40-18(b), the payment must be expensed.
An entity that issues zero-coupon bonds to an investor records the proceeds from the bonds’ issuance as a financing cash inflow. Unless the debtor elects to account for the bonds at fair value under the fair value option, the bonds are accreted to their redemption value in accordance with the interest method (see Section 6.2); that is, the carrying amount of the bonds increases from issuance until maturity (or earlier if prepayment is allowed) for the accrued interest to arrive at the bonds’ redemption value. On the maturity date (or earlier if prepayment is allowed), the entity repays (1) the original proceeds (the principal amount of the bonds) and (2) the accrued interest from the date of issuance. Before the bonds’ maturity (or the date of prepayment, if earlier), the interest expense is presented in the statement of cash flows as a reconciling item between net income and cash flows from operating activities, since no interim cash payments are made for the periodic accrual of interest. At redemption, the cash paid to settle the interest component is reflected as a cash outflow from operating activities in the statement of cash flows in accordance with ASC 230-10-45-17(d) as the accrued interest is recognized in earnings. The cash paid to settle the principal component (excluding the interest component) is reflected as a cash outflow from financing activities in the statement of cash flows in accordance with ASC 230-10-45-15(b). For an illustration of this accounting, see Example 6-9 in Deloitte's A Roadmap to the Preparation of the Statement of Cash Flows.

In addition to zero-coupon bonds, the guidance in ASC 230-10-45-17(d) also applies to other debt instruments “with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing that is attributable to the principal.” The objective of including these other debt instruments (rather than all debt instruments) is to improve comparability related to entities’ presentation of economically similar transactions. ASC 230 does not define the term “insignificant” or otherwise provide guidance on what would constitute insignificant coupon rates. Consequently, entities that issue other debt instruments with coupon rates that are insignificant in relation to the effective interest rate attributable to the principal will most likely need to exercise greater judgment in evaluating the portion of the rates that is insignificant. We generally believe that an entity should determine whether an interest rate is insignificant by looking to the market. For example, a 1 percent coupon rate may not be insignificant if the market rate is 2 percent. However, an entity may conclude that a 1 percent coupon rate is insignificant compared with a market rate of 10 percent.

As discussed in Section 6.4.3 of Deloitte’s A Roadmap to the Preparation of the Statement of Cash Flows, the guidance in ASC 230-10-45-17(d) applies to all debt instruments that are economically similar to zero-coupon instruments, including debt instruments that contain periodic interest coupons that are payable in kind.

For additional discussion about the application of ASC 230, see Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share.

### 14.3.3 Earnings per Share

While a detailed discussion of the guidance in ASC 260-10 is beyond the scope of this Roadmap, this section briefly discusses how debt could affect an issuer’s EPS calculations. For a comprehensive discussion of the guidance in ASC 260-10, see Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.
14.3.3.1 Participating Securities

Sometimes, debt securities (e.g., certain convertible debt) have a nondiscretionary and objectively determinable participation right in the debtor’s undistributed earnings (e.g., a right to participate on an if-converted basis in any dividends or other distributions to holders of common stock). For such securities, the debtor should consider whether EPS must be calculated by using the two-class method under ASC 260. The two-class method applies to both basic and diluted EPS. Potential common shares (e.g., convertible debt) are subject to the two-class method of calculating diluted EPS if the effect is more dilutive than the application of another dilutive method of calculating diluted EPS (i.e., the treasury stock, if-converted, or contingently issuable share method). For a detailed discussion of these requirements, see Chapter 5 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

14.3.3.2 Convertible Debt

When debt is convertible into the debtor’s shares of common stock, the debtor should determine if the if-converted or treasury stock method should be applied in the computation of diluted EPS. If the convertible debt is a participating security, the two-class method should be applied in the computation of diluted EPS if it is more dilutive than the otherwise applicable method, see Section 14.3.3.1 above.

If a convertible debt instrument does not represent a participating security and cannot be settled in cash upon conversion, the if-converted method is used to reflect the impact of the embedded conversion option on diluted EPS. 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. For a detailed discussion of these requirements, see Sections 4.4 and 6.2 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

If a convertible debt instrument does not represent a participating security and the debtor can settle all or a portion of it in cash or common stock upon conversion, the debtor must consider the guidance in ASC 260 on contracts that may be settled in stock or cash. Under that guidance, an entity presumes that a contract that may be settled in either cash or stock 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. If the debtor determines that the principal amount will be settled in cash and the conversion spread in shares, the treasury stock method should be applied in the computation of diluted EPS. If the debtor determines that the entire obligation will be settled in shares, the if-converted method applies. Additional considerations are necessary if the assumed method for diluted EPS purposes differ from the accounting treatment applicable to the convertible debt (e.g., a numerator adjustment may be required if the conversion feature is assumed to be settled in cash for EPS purposes, but is treated as equity for accounting purposes). For a detailed discussion of these requirements, see Sections 4.2, 4.7, and 6.3 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*. 
Special considerations are necessary if:

- An induced conversion occurs (see Section 6.6.1 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share).
- The conversion feature is nonsubstantive at inception and becomes exercisable only upon the exercise of a call option (see Section 6.6.2 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 815-15 or 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).
- The conversion feature is contingent (see Section 4.4.3 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share).

### 14.4 Disclosure

#### 14.4.1 Significant Debt Terms

<table>
<thead>
<tr>
<th>ASC 470-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-5</strong> Paragraph 505-10-50-3 requires that an entity explain, in summary form within its financial statements, the pertinent rights and privileges of various securities outstanding.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 505-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-3</strong> 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).</td>
</tr>
</tbody>
</table>

For each debt instrument outstanding, a debtor is required to disclose summary information about the rights and privileges (i.e., significant terms) of each debt instrument outstanding, such as participation rights, call prices and dates, and sinking fund requirements. (Disclosures about equity conversion terms are addressed in Section 14.4.9.)
SEC Rules, Regulations, and Interpretations

Regulation S-X, Rule 5-02, Balance Sheets [Reproduced in ASC 210-10-S99-1]

The purpose of this rule is to indicate the various line items and certain additional disclosures which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the balance sheets or related notes filed for the persons to whom this article pertains (see § 210.4-01(a)). . . .

22. Bonds, mortgages and other long-term debt, including capitalized leases.

(a) State separately, in the balance sheet or in a note thereto, each issue or type of 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. For amounts owed to related parties, see § 210.4-08(k). . . .

SEC registrants must disclose the following information for each issue or type of obligation of bonds, mortgages, and other long-term debt either on the face of the balance sheet or in a note:

- The general character of each debt type.
- The interest rate.
- The maturity date or, for serial-maturity debt (e.g., amortizing debt), the serial maturity period.
- An indication of any contingency associated with the payment of principal or interest (e.g., additional interest contingent upon an event of default or delayed filings).
- Priority (e.g., senior or subordinated debt).
- If applicable, conversion terms.

14.4.2 Face Amount and Effective Interest Rate

ASC 835-30

45-1 The guidance in this Section does not apply to the amortization of premium and discount of assets and liabilities that are reported at fair value and the debt issuance costs of liabilities that are reported at fair value.

45-1A The discount or premium resulting from the determination of present value in cash or noncash transactions is not an asset or liability separable from the note that gives rise to it. Therefore, the discount or premium shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Similarly, 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. The discount, premium, or debt issuance costs shall not be classified as a deferred charge or deferred credit.

45-2 The description of the note shall include the effective interest rate. The face amount also shall be disclosed in the financial statements or in the notes to the statements.

Pending Content (Transition Guidance: ASC 105-10-65-6)

45-2 Paragraph 835-30-45-1A provides requirements for the balance sheet presentation for the discount or premium and debt issuance costs of a note. The description of the note shall include the effective interest rate. The face amount of the note also shall be presented in the financial statements or disclosed in the notes to financial statements. (See paragraph 835-30-50-1.)
For each debt instrument outstanding, a debtor must provide the following information either in the notes or on the face of the financial statements:

- The face amount (i.e., the stated principal amount).
- The effective interest rate that is used for accounting purposes (see Section 6.2.3.3).

The debt’s face amount may differ from its net carrying amount because the debt was issued at a discount or premium (see Chapter 4), the debtor incurred debt issuance costs (see Chapter 5), or the debt proceeds were attributable to multiple units of account, such as debt with detachable warrants (see Chapter 3). ASC 835-30-45-1A requires discounts, premiums, or issuance costs to be presented as a direct deduction or addition to the amount on the face of the balance sheet. In the income statement, the debtor reports the amortization of discounts, premiums, and issuance costs as interest expense (see ASC 835-30-45-3). However, the guidance in ASC 835-30-45 on the amortization of discounts, premiums, and issuance costs does not apply to debt reported at fair value, such as debt reported under the fair value option in ASC 815-15 or ASC 825-10 (see ASC 835-30-45-1).

### ASC 835-30

**Example 2: Balance Sheet Presentation of Discounted Notes**

55-8 This Example is an illustration of the guidance in paragraphs 835-30-45-1 through 45-3 related to the balance sheet presentation of notes that are discounted.

<table>
<thead>
<tr>
<th>Description</th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20X2</td>
</tr>
<tr>
<td>Presentation 1 — Discount presented in caption</td>
<td></td>
</tr>
<tr>
<td>Note Receivable From Sale of Property:</td>
<td></td>
</tr>
<tr>
<td>$1,000,000 face amount, noninterest bearing, due December 31, 20X9 (less unamortized discount based on imputed interest rate of 8% — 20X2, $320,000; 20X1, $370,000)</td>
<td>$680,000</td>
</tr>
<tr>
<td>Presentation 2 — Discount presented separately</td>
<td></td>
</tr>
<tr>
<td>Note Receivable From Sale of Property:</td>
<td></td>
</tr>
<tr>
<td>Noninterest bearing note due December 31, 20X9</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less unamortized discount based on imputed interest rate of 8%</td>
<td>320,000</td>
</tr>
<tr>
<td>Note receivable less unamortized discount</td>
<td>$680,000</td>
</tr>
<tr>
<td>Presentation 3 — Several notes involved</td>
<td></td>
</tr>
<tr>
<td>Long-Term Debt (Note 1):</td>
<td></td>
</tr>
<tr>
<td>Principal amount</td>
<td>$24,200,000</td>
</tr>
<tr>
<td>Less unamortized discount and debt issuance costs</td>
<td>2,680,000</td>
</tr>
<tr>
<td>Long-term debt less unamortized discount and debt issuance costs</td>
<td>$21,520,000</td>
</tr>
</tbody>
</table>
Note 1 — Long-Term Debt

Long-term debt at December 31, 20X2, consisted of the following:

<table>
<thead>
<tr>
<th>Principal</th>
<th>Unamortized Discount and Debt Issuance Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>6% subordinated debentures, due 20X9 (discount is based on imputed interest rate of 7%)</td>
<td>$20,000,000  $2,150,000</td>
</tr>
<tr>
<td>6½% bank loan, due 20X7</td>
<td>3,000,000  120,000</td>
</tr>
<tr>
<td>Noninterest bearing note issued in connection with acquisition of property, due 20X9 (discount is based on imputed interest rate of 8%)</td>
<td>1,200,000  410,000</td>
</tr>
<tr>
<td>Total</td>
<td>$24,200,000  $2,680,000</td>
</tr>
</tbody>
</table>

ASC 835-30-55-8 illustrates the presentation and disclosure of (1) a noninterest bearing note receivable with an imputed discount and (2) long-term debt issued at a discount and for which debt issuance costs were incurred. The illustration shows how the discount and issuance costs related to a debt instrument may be presented either in the line item caption for the debt or broken out as a separate amount on the face of the balance sheet. Further, it displays how the notes may show a breakdown of individual debt instruments along with their amounts of debt discounts and issuance costs when the balance sheet line item includes multiple debt instruments. If a debt instrument was issued at a premium instead of a discount, the related descriptions would be amended accordingly.

14.4.3 Pledged Assets and Restrictive Debt Covenants

ASC 440-10

50-1 Notwithstanding more explicit disclosures required elsewhere in this Codification, all of the following situations shall be disclosed in financial statements: . . .

c. Assets pledged as security for loans . . .

f. Commitments, including: . . .

2. An obligation to reduce debts
3. An obligation to maintain working capital
4. An obligation to restrict dividends.

Nonauthoritative AICPA Guidance

Technical Q&As Section 3500, “Commitments”

.06 Covenants Imposed by Loan Agreements

Inquiry — Restrictive covenants under certain loan agreements of Company A require the Company to maintain a special level of working capital, reduce the amount of its debts, and restrict the amount of retained earnings available for dividend payments. Should the restrictive covenants be disclosed?

Reply — FASB ASC 440-10-50-1 requires the disclosure of restrictive covenants.
A debtor is required to disclose information about assets pledged as collateral for debt and restrictive debt covenants, such as commitments to maintain a specific amount of working capital (see Section 13.3.3.2), reduce the amount of debt, or restrict dividend payments (e.g., provisions that prevent the payment of dividends on common or preferred stock).

14.4.4 Weighted Average Interest Rate on Short-Term Borrowings

<table>
<thead>
<tr>
<th>SEC Rules, Regulations, and Interpretations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regulation S-X, Rule 5-02, Balance Sheets [Reproduced in ASC 210-10-S99-1]</strong></td>
</tr>
<tr>
<td>The purpose of this rule is to indicate the various line items and certain additional disclosures which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the balance sheets or related notes filed for the persons to whom this article pertains (see § 210.4-01(a)). . . .</td>
</tr>
<tr>
<td>19. Accounts and notes payable. . . .</td>
</tr>
<tr>
<td>(b) . . . The weighted average interest rate on short term borrowings outstanding as of the date of each balance sheet presented shall be furnished in a note. . . .</td>
</tr>
</tbody>
</table>

SEC registrants must disclose in a note the weighted average interest rate on short-term borrowings outstanding as of each balance sheet date.

14.4.5 Defaulted Debt, Covenant Violations, and Waivers

<table>
<thead>
<tr>
<th>SEC Rules, Regulations, and Interpretations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regulation S-X, Rule 4-08, General Notes to Financial Statements [Reproduced in ASC 235-10-S99-1]</strong></td>
</tr>
<tr>
<td>If applicable to the person for which the financial statements are filed, the following shall be set forth on the face of the appropriate statement or in appropriately captioned notes. The information shall be provided for each statement required to be filed, except that the information required by paragraphs (b), (c), (d), (e) and (f) of this section shall be provided as of the most recent audited balance sheet being filed and for paragraph (i) of this section as specified therein. When specific statements are presented separately, the pertinent notes shall accompany such statements unless cross-referencing is appropriate. . . .</td>
</tr>
<tr>
<td>(c) Defaults. The facts and amounts concerning any default in principal, interest, sinking fund, or redemption provisions with respect to any issue of securities or credit agreements, or any breach of covenant of a related indenture or agreement, which default or breach existed at the date of the most recent balance sheet being filed and which has not been subsequently cured, shall be stated in the notes to the financial statements. If a default or breach exists but acceleration of the obligation has been waived for a stated period of time beyond the date of the most recent balance sheet being filed, state the amount of the obligation and the period of the waiver. . . .</td>
</tr>
</tbody>
</table>
SEC registrants must disclose information about:

- Debt in default, including “the facts and amounts concerning any default in principal, interest, sinking fund, or redemption provisions.”
- Covenant violations, including “any breach of covenant of a related indenture or agreement, which default or breach existed at the date of the most recent balance sheet being filed and which has not been subsequently cured.”
- Waivers of defaults and covenant violations, including “the amount of the obligation and the period of the waiver.”

### 14.4.6 Five-Year Table of Debt Maturities

<table>
<thead>
<tr>
<th>ASC 470-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-1</strong> The combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings shall be disclosed for each of the five years following the date of the latest balance sheet presented. (See Section 505-10-50 for disclosure guidance that applies to securities, including debt securities.) See Example 3 (paragraph 470-10-55-10) for an illustration of this disclosure requirement.</td>
</tr>
<tr>
<td><strong>50-2</strong> If an obligation under paragraph 470-10-45-11(b) is classified as a long-term liability (or, in the case of an unclassified balance sheet, is included as a long-term liability in the disclosure of debt maturities), the circumstances shall be disclosed.</td>
</tr>
</tbody>
</table>

**Example 3: Disclosure of Long-Term Obligations**

**55-10** This Example provides an illustration of the guidance in paragraph 470-10-50-1 for disclosures for long-term borrowings and preferred stock with mandatory redemption requirements. This Example has the following assumptions.

**55-11** Entity D has outstanding two long-term borrowings and one issue of preferred stock with mandatory redemption requirements. The first borrowing is a $100 million sinking fund debenture with annual sinking fund payments of $10 million in 19X2, 19X3, and 19X4, $15 million in 19X5 and 19X6, and $20 million in 19X7 and 19X8. The second borrowing is a $50 million note due in 19X5. The $30 million issue of preferred stock requires a 5 percent annual cumulative sinking fund payment of $1.5 million until retired.

**55-12** Entity D’s disclosure might be as follows.

Maturities and sinking fund requirements on long-term debt and sinking fund requirements on preferred stock subject to mandatory redemption are as follows (in thousands).

<table>
<thead>
<tr>
<th></th>
<th>Long-term debt</th>
<th>Preferred stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>19X2</td>
<td>$ 10,000</td>
<td>$ 1,500</td>
</tr>
<tr>
<td>19X3</td>
<td>10,000</td>
<td>1,500</td>
</tr>
<tr>
<td>19X4</td>
<td>10,000</td>
<td>1,500</td>
</tr>
<tr>
<td>19X5</td>
<td>65,000</td>
<td>1,500</td>
</tr>
<tr>
<td>19X6</td>
<td>15,000</td>
<td>1,500</td>
</tr>
</tbody>
</table>
A debtor is required to disclose the aggregate amount of maturities (i.e., principal repayments) of long-term debt during each of the five annual periods after the balance sheet date (ASC 470-10-50-1 and 470-10-55-12). The amounts disclosed do not include interest payments (AICPA Technical Q&As Section 3200.15).

If a debtor has included a long-term obligation in the table of maturities of long-term obligation in the following scenario, it must disclose the circumstances (ASC 470-10-50-2; see also Section 13.5.4):

- The debtor has violated a provision of the debt.
- The debt will become repayable on demand if the debtor does not cure the violation within a specified grace period.
- It is probable that the debtor will cure the violation within the grace period.

14.4.7 Significant Changes in Outstanding Debt

SEC registrants must disclose information about significant changes in the authorized or outstanding amount of bonds, mortgages, and similar debt since the most recent balance sheet date.

14.4.8 Unused Lines of Credit and Other Loan Commitments

ASC 440-10

50-1 Notwithstanding more explicit disclosures required elsewhere in this Codification, all of the following situations shall be disclosed in financial statements:

a. Unused letters of credit . . . .
Chapter 14 — Presentation, Disclosure, and Other Considerations

SEC Rules, Regulations, and Interpretations

Regulation S-X, Rule 5-02, Balance Sheets [Reproduced in ASC 210-10-S99-1]

The purpose of this rule is to indicate the various line items and certain additional disclosures which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the balance sheets or related notes filed for the persons to whom this article pertains (see § 210.4-01(a)). . . .

19. Accounts and notes payable. . . .

(b) The amount and terms (including commitment fees and the conditions under which lines may be withdrawn) of unused lines of credit for short-term financing shall be disclosed, if significant, in the notes to the financial statements. The weighted average interest rate on short term borrowings outstanding as of the date of each balance sheet presented shall be furnished in a note. The amount of these lines of credit which support a commercial paper borrowing arrangement or similar arrangements shall be separately identified. . . .

22. Bonds, mortgages and other long-term debt, including capitalized leases. . . .

(b) The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of unused commitments for long-term financing arrangements that would be disclosed under this rule if used shall be disclosed in the notes to the financial statements if significant. . . .

SEC Rules, Regulations, and Interpretations

FRR 203.04. Unused Lines of Credit or Commitments (ASR 148)

Rules 5-02.19 and 5-02.22 of Regulation S-X . . . . call for the disclosure of the amount and terms of unused lines of credit and commitments if significant. Various factors should be considered in determining significance such as total debt by term of such debt, total capital, total cash requirements, and the like.

The disclosure of unused lines and commitments supplies the investor with information regarding borrowing potential and future liquidity under varying money market conditions. It is recognized that lines of credit or commitments are frequently extended to a borrower subject to the condition that the borrower maintain certain standards of credit worthiness, and that the existence of such lines or commitments therefore does not assure the availability of credit under conditions of deteriorating financial position. Accordingly, the rule provides that disclosure be made of the conditions under which lines or commitments may be withdrawn.

It is also recognized that such lines and commitments are occasionally offered by financial institutions as a marketing device and accepted by corporations without any intention of use and not as part of their financing plan. Disclosure of such lines is not contemplated by this rule.

Unused lines disclosed as supporting commercial paper or other debt arrangements should include only usable lines. For this purpose usable lines are construed to be total lines used to support commercial paper less lines needed to meet “clean-up” provisions of a borrowing arrangement. Such provisions require borrowers to retire credit extended at a bank or banks at some specified interval for a specified period. Total lines outstanding are therefore not necessarily a measure of the total credit available on a continuing basis. Similarly, if a corporation has lines arranged with several banks which in total exceed borrowing levels permitted under existing lending agreements, disclosure should be limited to usable amounts.

Rule 5-02.22 would include disclosure of commitments such as standby commitments, commitments for future disbursements, and unused revolving credits maturing after one year.
Nonauthoritative AICPA Guidance

Technical Q&As Section 3500, “Commitments”

.07 Disclosure of Unused Lines of Credit

Inquiry — Should nonpublic companies disclose the existence of unused lines of credit that are available as of the balance sheet date?

Reply — Although public companies are required [pursuant to SEC Regulation S-X, section 210.5-02.19(b)] to disclose significant unused lines of credit for short-term financing in the notes, there is no such explicit requirement for nonpublic companies under generally accepted accounting principles. However, under certain circumstances, disclosure by nonpublic companies may be advisable based on the general principle of adequate disclosure.

The notes, as well as the financial statements, should be informative of matters that may affect their use, understanding, and interpretation.

Regulation S-X, Rule 5-02, requires SEC registrants to disclose the “amount and terms (including commitment fees and the conditions under which lines may be withdrawn)” of significant unused (1) lines of credit for short-term financing and (2) commitments for long-term financing arrangements, such as “standby commitments, commitments for future disbursements, and unused revolving credits maturing after one year.” FRR 203.04 indicates that an entity should consider “various factors . . . in determining significance such as total debt by term of such debt, total capital, total cash requirements.”

Lines of credit that “support a commercial paper borrowing arrangement or similar arrangements” must be identified separately. The purpose of the requirement to disclose the conditions under which lines of credit and other commitments may be drawn is to help investors assess “the availability of credit under conditions of deteriorating financial position” (e.g., whether the availability of the commitment depends on the entity’s creditworthiness).

AICPA Technical Q&As Section 3500.07 suggests that there is no explicit requirement for nonpublic companies to disclose unused lines of credit. However, ASC 440-10-50-1(a) requires disclosure of unused letters of credit. Some interpret that guidance broadly to require disclosure of any unused loan commitments obtained (including unused lines of credit).

14.4.9 Convertible Debt

14.4.9.1 General

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).

50-7 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.
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.

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.

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 convertible securities irrespective of whether they are in the form of debt or equity (see, for example, 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 discusses how to apply the disclosure requirement in ASC 505-10-50-3 related to &quot;conversion or exercise prices or rates and pertinent dates&quot; to convertible instruments with a BCF. Accordingly, the cross-reference in ASC 505-10-50-7 to &quot;the preceding paragraph&quot; 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, ASC 505-10-50-9, and ASC 505-10-50-10</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.
ASC 470-20-50-3 through 50-6 require incremental disclosures about convertible debt within the scope of the cash conversion guidance in ASC 470-20. For a discussion of these disclosure requirements, see Section 6.6.3 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

### 14.4.9.2 Contingently Convertible Debt

**ASC 505-10**

**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).

**50-9** 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.

For contingently convertible securities, an issuer should disclose additional information, such as:

- The nature of the contingency and the potential effect of conversion, including:
  - Events or changes in circumstances that would cause the contingency to be met.
  - 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).
  - The conversion price.
  - The number of shares into which a security is potentially convertible.
  - 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.
The manner of settlement upon conversion (e.g., cash, shares, or a combination).

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 (e.g., capped call options or call spread transactions), 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.

### 14.4.9.3 Convertible Debt Within the Scope of the CCF Guidance in ASC 470-20

#### ASC 470-20

**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.
ASC 470-20 (continued)

**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.

**50-6** 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 (see Section 7.6.4) 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>

The guidance in ASC 825-10 does not address whether the disclosure requirements related to fair value in ASC 825-10-50 (see Section 14.4.10 below) 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 that there is no specific scope exception in ASC 825-10-50 for the equity-classified component of an instrument.

- 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 that this scope exception applies to the equity component of instruments that have been separated into liability and equity components.
14.4.10 Fair Value Information

ASC 825-10

50-2A The disclosure guidance in this Subsection applies to public business entities.

50-8 In part, this Subsection requires disclosures about fair value for all financial instruments, whether recognized or not recognized in the statement of financial position, except that the disclosures about fair value prescribed in paragraphs 825-10-50-10 through 50-13 and 825-10-50-15 are not required for any of the following:

- b. Substantively extinguished debt subject to the disclosure requirements of Subtopic 405-20
- m. Trade receivables and payables due in one year or less
- n. Deposit liabilities with no defined or contractual maturities
- o. Liabilities resulting from the sale of prepaid stored-value products within the scope of paragraph 405-20-40-3.

50-9 Generally accepted accounting principles (GAAP) require disclosure of or subsequent measurement at fair value for many classes of financial instruments. Those requirements are not superseded or modified by this Subsection.

50-10 A reporting entity shall disclose either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments and the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3).

For financial instruments recognized at fair value in the statement of financial position, the disclosure requirements of Topic 820 also apply.

50-11 Fair value disclosed in the notes shall be presented together with the related carrying amount in a form that clarifies both of the following:

- a. Whether the fair value and carrying amount represent assets or liabilities
- b. How the carrying amounts relate to what is reported in the statement of financial position.

50-12 If the fair value of financial instruments is disclosed in more than a single note, one of the notes shall include a summary table. The summary table shall contain the fair value and related carrying amounts and cross-references to the location(s) of the remaining disclosures required by this Section.

50-15 In disclosing the fair value of a financial instrument, an entity shall not net that fair value with the fair value of other financial instruments — even if those financial instruments are of the same class or are otherwise considered to be related (for example, by a risk management strategy) — except to the extent that the offsetting of carrying amounts in the statement of financial position is permitted under either of the following:

- a. The general principle in paragraph 210-20-45-1
- b. The exceptions for master netting arrangements in paragraph 815-10-45-5 and for amounts related to certain repurchase and reverse repurchase agreements in paragraphs 210-20-45-11 through 45-17.
Under ASC 825-10, public business entities must disclose information about the fair value of financial assets and financial liabilities (such as debt, lines of credit, revolving-debt arrangements, and term loan commitments) except for financial instruments that are specifically exempt under ASC 825-10-50-8 (e.g., trade payables due in less than one year and obligations related to prepaid stored-value products). This disclosure requirement applies irrespective of whether a financial instrument is recognized in the financial statements and how it is measured (e.g., amortized cost). The required disclosures include:

- The fair value as of the reporting date (see Section 14.2.2).
- The level of the fair value hierarchy (Level 1, 2, or 3) within which each fair value measurement is categorized in its entirety (see Chapter 8 of Deloitte’s A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option)).

An entity may provide these disclosures either in the body of the financial statements or in the notes. If the information is provided in the notes, fair values must be presented “together with the related carrying amount” and it must be clear (1) “[h]ow the carrying amounts relate to what is reported” in the balance sheet and (2) whether the amounts represent assets or liabilities. If the information is included in more than one note, an entity must provide a summary table that contains the fair values and carrying amounts and cross-references to the locations of the remaining disclosures under ASC 825-10-50.

An entity cannot net the fair value of financial instruments unless the conditions in ASC 210-20 or ASC 815-10 for balance sheet offsetting are met (see Section 14.3.1.1). Further, the fair values disclosed should be consistent with the unit of account. For example, as discussed in ASC 825-10-25-13, “[f]or the issuer of a liability issued with an inseparable third-party credit enhancement . . . the unit of accounting for the liability . . . disclosed at fair value does not include the third-party credit enhancement.”

For financial instruments that are not measured at fair value in the financial statements after initial recognition, an entity is not required to provide the disclosures specified in ASC 820-10-50 (see Section 14.4.11), such as information about valuation techniques and inputs used, changes in the valuation approach or valuation technique, and significant unobservable inputs.

Entities other than public business entities are not required to provide disclosures about the fair value of financial assets and financial liabilities that are not measured at fair value in the statement of financial position.

### 14.4.11 Fair Value Option Liabilities

#### 14.4.11.1 General

<table>
<thead>
<tr>
<th>ASC 825-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-9</strong> Generally accepted accounting principles (GAAP) require disclosure of or subsequent measurement at fair value for many classes of financial instruments. Those requirements are not superseded or modified by this Subsection.</td>
</tr>
<tr>
<td><strong>50-27</strong> The disclosure requirements in paragraphs 825-10-50-28 through 50-30 do not eliminate disclosure requirements included in other Subtopics, including other disclosure requirements relating to fair value measurement. Entities are encouraged but are not required to present the disclosures required by this Subtopic in combination with related fair value information required to be disclosed by other Subtopics (for example, the General Subsection of this Section and Topic 820).</td>
</tr>
</tbody>
</table>
If a debtor has elected the fair value option in ASC 815-15 (see Section 8.5.6) or ASC 825-10 (see Section 4.4) for a financial liability, it must disclose comprehensive information about the related fair value measurements under ASC 820-10-50 and ASC 825-10-50. As discussed in ASC 825-10-50-9 and ASC 825-10-50-27, the disclosure requirements of other U.S. GAAP are not superseded by the incremental disclosure requirements in ASC 825-10-50 for items measured at fair value under the fair value option.

For a discussion of the disclosures required by ASC 820-10-50 and ASC 825-10-50, see Chapter 11 of Deloitte’s A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option). This section outlines the incremental disclosure requirements in ASC 825-10 that apply to financial liabilities for which the fair value option has been elected.

**14.4.11.2 Objective**

<table>
<thead>
<tr>
<th>ASC 825-10</th>
</tr>
</thead>
</table>
| **50-24** The principal objectives of the disclosures required by paragraphs 825-10-50-28 through 50-32 are to facilitate both of the following comparisons:
| a. Comparisons between entities that choose different measurement attributes for similar assets and liabilities
| b. Comparisons between assets and liabilities in the financial statements of an entity that selects different measurement attributes for similar assets and liabilities.
| **50-25** Those disclosure requirements are expected to result in the following:
| a. Information to enable users of its financial statements to understand management’s reasons for electing or partially electing the fair value option
| b. Information to enable users to understand how changes in fair values affect earnings for the period
| c. The same information about certain items (such as equity investments and nonperforming loans) that would have been disclosed if the fair value option had not been elected
| d. Information to enable users to understand the differences between fair values and contractual cash flows for certain items.

To meet those objectives, the disclosures described in paragraphs 825-10-50-28 through 50-32 are required for items measured at fair value under the option in this Subtopic and the option in paragraph 815-15-25-4. Those disclosures are not required for securities classified as trading securities under Topic 320, life settlement contracts measured at fair value pursuant to Subtopic 325-30, or servicing rights measured at fair value pursuant to Subtopic 860-50. Those Subtopics include disclosure requirements not affected by this Subtopic.

| **50-26** Entities shall provide the disclosures required by paragraphs 825-10-50-28 through 50-32 in both interim and annual financial statements.

ASC 825-10-50-24 through 50-26 identify the objectives of the disclosure requirements for items measured at fair value in accordance with the fair value option in ASC 825-10 or ASC 815-15 (e.g., comparability with similar items not measured at fair value by the same entity or other entities).
14.4.11.3 Balance Sheet Disclosures

ASC 825-10

50-28 As of each date for which a statement of financial position is presented, entities shall disclose all of the following:

a. Management’s reasons for electing a fair value option for each eligible item or group of similar eligible items.

b. If the fair value option is elected for some but not all eligible items within a group of similar eligible items, both of the following:
   1. A description of those similar items and the reasons for partial election.
   2. Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position.

c. For each line item in the statement of financial position that includes an item or items for which the fair value option has been elected, both of the following:
   1. Information to enable users to understand how each line item in the statement of financial position relates to major classes of assets and liabilities presented in accordance with the fair value disclosure requirements of Topic 820. (Paragraph 825-10-50-11 also requires an entity to relate carrying amounts that are disclosed in accordance with that paragraph to what is reported in the statement of financial position.)
   2. The aggregate carrying amount of items included in each line item in the statement of financial position that are not eligible for the fair value option, if any.

d. The difference between the aggregate fair value and the aggregate unpaid principal balance of each of the following:
   1. Long-term debt instruments that have contractual principal amounts and for which the fair value option has been elected.

For each interim or annual period with a statement of financial position, the disclosures above are required for items accounted for at fair value by using the fair value option, including information about:

- Management’s reasons for electing the fair value option.
- How balance sheet line items with items for which the fair value option has been elected are related to major classes of assets and liabilities for which fair value disclosures are provided under ASC 820.
- The aggregate amount of ineligible items included in line items with items for which the fair value option has been elected and those not eligible for the fair value option.
- The difference between the aggregate fair value and the aggregate unpaid principal balance of long-term debt instruments for which an entity has elected the fair value option.

See Section 14.4.11.6 for examples illustrating these disclosures.
14.4.11.4 Income Statement Disclosures

<table>
<thead>
<tr>
<th>ASC 825-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-30</strong> For each period for which an income statement is presented, entities shall disclose all of the following about items for which the fair value option has been elected:</td>
</tr>
<tr>
<td>a. For each line item in the statement of financial position, the amounts of gains and losses from fair value changes included in earnings during the period and in which line in the income statement those gains and losses are reported. This Subtopic does not preclude an entity from meeting this requirement by disclosing amounts of gains and losses that include amounts of gains and losses for other items measured at fair value, such as items required to be measured at fair value.</td>
</tr>
<tr>
<td>b. A description of how interest and dividends are measured and where they are reported in the income statement. This Subtopic does not address the methods used for recognizing and measuring the amount of dividend income, interest income, and interest expense for items for which the fair value option has been elected. . . .</td>
</tr>
<tr>
<td>d. For liabilities, all of the following about the effects of the instrument-specific credit risk and changes in it:</td>
</tr>
<tr>
<td>1. The amount of change, during the period and cumulatively, of the fair value of the liability that is attributable to changes in the instrument-specific credit risk . . . .</td>
</tr>
<tr>
<td>3. How the gains and losses attributable to changes in instrument-specific credit risk were determined.</td>
</tr>
<tr>
<td>4. If a liability is settled during the period, the amount, if any, recognized in other comprehensive income that was recognized in net income at settlement.</td>
</tr>
</tbody>
</table>

For each interim or annual period with an income statement, the disclosures above are required for items accounted for at fair value by using the fair value option. See Section 14.4.11.6 for examples illustrating these disclosures. ASC 825-10 does not prescribe how an entity should report gains and losses within the income statement.

Note that a debtor must disclose information about the effects of instrument-specific credit risk and changes in it related to financial liabilities for which it has elected the fair value option.

14.4.11.5 Other Required Disclosures

<table>
<thead>
<tr>
<th>ASC 825-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-31</strong> In annual periods only, an entity shall disclose the methods and significant assumptions used to estimate the fair value of items for which the fair value option has been elected. For required disclosures about the method(s) and significant assumptions used to estimate the fair value of financial instruments, see paragraph 820-10-50-2(bbb) except that an entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy required by that paragraph.</td>
</tr>
<tr>
<td><strong>50-32</strong> If an entity elects the fair value option at the time one of the events in paragraph 825-10-25-4(d) through (e) occurs, the entity shall disclose both of the following in financial statements for the period of the election:</td>
</tr>
<tr>
<td>a. Qualitative information about the nature of the event</td>
</tr>
<tr>
<td>b. Quantitative information by line item in the statement of financial position indicating which line items in the income statement include the effect on earnings of initially electing the fair value option for an item.</td>
</tr>
</tbody>
</table>

In annual periods, an entity that has elected the fair value option must disclose the methods and significant assumptions used to estimate fair value, including the information required to be disclosed under ASC 820-10-50-2(bbb). See Chapter 11 of Deloitte’s A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option) for more information about these disclosures.
ASC 825-10-50-32 contains additional disclosure requirements related to fair value option elections that occur after a qualifying event under ASC 825-10-25-4(d) and (e). Those events are discussed in Sections 12.3.2.1 and 12.3.2.2 of Deloitte’s *A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option)*.

### 14.4.11.6 Illustrations

<table>
<thead>
<tr>
<th>ASC 825-10</th>
</tr>
</thead>
</table>

**Example 1: Fair Value Measurements and Changes in Fair Values Included in Current-Period Earnings**

55-6 The following Cases illustrate selected disclosure requirements for items reported at fair value under this Subtopic:

  

55-7 Cases A and B represent suggested forms for presenting disclosure information. While the suggested forms of presentation illustrate selected required disclosures, the suggested forms of presentation are not mandated by this Subtopic. Aggregation of related fair value disclosures is encouraged but not required.
The statement of financial position for Entity XYZ as of December 31, 20X1, is provided to assist in understanding the illustrative fair value disclosures in Cases A and B.

<table>
<thead>
<tr>
<th>Description</th>
<th>At December 31, 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash and due from banks</td>
<td>$ 38</td>
</tr>
<tr>
<td>Deposits with banks</td>
<td>22</td>
</tr>
<tr>
<td>Fed funds sold and securities purchased under resale agreements</td>
<td>134</td>
</tr>
<tr>
<td>Securities borrowed</td>
<td>75</td>
</tr>
<tr>
<td>Trading debt securities</td>
<td>115</td>
</tr>
<tr>
<td>Debt securities available-for-sale (net allowance for credit losses of $3)</td>
<td>75</td>
</tr>
<tr>
<td>Debt securities held-to-maturity</td>
<td>$ 34</td>
</tr>
<tr>
<td>Allowance for credit losses on held-to-maturity debt securities</td>
<td>(2)</td>
</tr>
<tr>
<td>Debt securities held-to-maturity, net of allowance for credit losses</td>
<td>32</td>
</tr>
<tr>
<td>Loans and lease receivables ($150 at fair value)</td>
<td>$ 560</td>
</tr>
<tr>
<td>Allowance for credit losses on loan and lease receivables</td>
<td>(10)</td>
</tr>
<tr>
<td>Loans and lease receivables, net of allowance for credit losses</td>
<td>550</td>
</tr>
<tr>
<td>Derivatives</td>
<td>60</td>
</tr>
<tr>
<td>Equity investments</td>
<td>125</td>
</tr>
<tr>
<td>Premises and equipment</td>
<td>10</td>
</tr>
<tr>
<td>Other assets</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$ 1,256</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Non-interest-bearing deposits</td>
<td>$ 143</td>
</tr>
<tr>
<td>Interest-bearing deposits</td>
<td>412</td>
</tr>
<tr>
<td>Fed funds purchased and securities sold under repurchase agreements</td>
<td>130</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>110</td>
</tr>
<tr>
<td>Short-term borrowings</td>
<td>128</td>
</tr>
<tr>
<td>Long-term debt ($60 at fair value)</td>
<td>200</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>1,123</td>
</tr>
<tr>
<td><strong>Shareholders' equity</strong></td>
<td></td>
</tr>
<tr>
<td>Common stock (authorized 5,000,000 shares; issued 3,550,000 shares)</td>
<td>4</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>88</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>42</td>
</tr>
<tr>
<td>Accumulated other comprehensive income (loss)</td>
<td>(1)</td>
</tr>
<tr>
<td><strong>Total shareholders' equity</strong></td>
<td>133</td>
</tr>
<tr>
<td><strong>Total liabilities and shareholders' equity</strong></td>
<td>$ 1,256</td>
</tr>
</tbody>
</table>
**Case A: Disclosures With Voluntary Integration**

**55-9** The objective is to provide information about all of the following:

a. Assets and liabilities measured at fair value on a recurring basis (as required by Subtopic 820-10)
b. Changes in fair values of assets and liabilities for which the fair value option has been elected in a manner that relates to the statement of financial position (as required by this Subtopic)
c. Fair value estimates and corresponding carrying amounts for major categories of assets and liabilities that include items measured at fair value on a recurring basis (in accordance with the General Subsection of 825-10-50).

**55-10** The following table represents the fair value tabular disclosure required by paragraph 820-10-50-2(b), supplemented to do both of the following:

a. Provide information about where in the income statement changes in fair values of assets and liabilities reported at fair value are included in earnings
b. Voluntarily integrate selected disclosures required annually by the General Subsection of 825-10-50.

Disclosures required by paragraphs 825-10-50-28(c) and 825-10-50-30(a) are illustrated in the narrative disclosure that follows the table.

<table>
<thead>
<tr>
<th>Description</th>
<th>Total Carrying Amount in Statement of Financial Position 12/31/X1</th>
<th>Fair Value Estimate 12/31/X1</th>
<th>Assets or Liabilities Measured at Fair Value 12/31/X1</th>
<th>Quoted Prices in Active Markets for Identical Assets (Level 1)</th>
<th>Significant Other Observable Inputs (Level 2)</th>
<th>Significant Unobservable Inputs (Level 3)</th>
<th>Changes in Fair Values for the 12-Month Period Ended December 31, 20X1, for Items Measured at Fair Value Pursuant to Election of the Fair Value Option</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$115</td>
<td>$115</td>
<td>$115</td>
<td>$105</td>
<td>$10</td>
<td>$10</td>
<td>$10</td>
</tr>
<tr>
<td>Trading debt securities</td>
<td>75</td>
<td>75</td>
<td>75</td>
<td>75</td>
<td></td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Available-for-sale debt securities</td>
<td>400</td>
<td>400</td>
<td>150</td>
<td>—</td>
<td>100</td>
<td>50</td>
<td>$ (3)</td>
</tr>
<tr>
<td>Loans, net</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>25</td>
<td>15</td>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>Derivatives</td>
<td>125</td>
<td>125</td>
<td>125*</td>
<td>50</td>
<td>25</td>
<td>50</td>
<td>5</td>
</tr>
<tr>
<td>Equity investments</td>
<td>(200)</td>
<td>(206)</td>
<td>(60)</td>
<td>(40)</td>
<td>(20)</td>
<td></td>
<td>13</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>$ (4)</td>
<td>$ (4)</td>
<td>$ (4)</td>
<td>$ (4)</td>
<td>$ (4)</td>
<td></td>
<td>4</td>
</tr>
</tbody>
</table>

(*) Includes investments that would otherwise be accounted for under the equity method of accounting.

Loans are included in loans and lease receivables in the statement of financial position. As of December 31, 20X1, approximately $160,000 of lease receivables are included in loans and lease receivables in the statement of financial position and are not eligible for the fair value option.

“**(c)**” This column discloses carrying amount information required annually by this Subtopic only for major categories of assets and liabilities that include items measured at fair value.

“**(d)**” This column discloses fair value estimates required annually by this Subtopic only for major categories of assets and liabilities that include items measured at fair value. This Subtopic requires an entity to disclose fair value estimates and related carrying amounts for all financial instruments within the scope of this Subtopic. Paragraph 825-10-50-12 requires that if an entity discloses the fair value of financial instruments in more than a single note, one of the notes include a summary table (not presented in this Example).

“**(e)**” This Subtopic does not require disclosure of the amounts in the Trading Gains and Losses column nor does it preclude disclosure of these amounts. These amounts are shown for completeness.
55-11 An entity might provide either of the following additional disclosures required by paragraph 825-10-50-28(a) through (b) after the following table:

a. Management's reasons for electing a fair value option for each eligible item or group of similar eligible items
b. If the fair value option is elected for some but not all eligible items within a group of similar eligible items, both of the following:
   1. A description of those similar items and the reasons for partial election
   2. Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position.

55-12 The following table illustrates an alternative presentation that does not integrate disclosures required annually by this Subtopic or the additional gain and loss amounts voluntarily displayed in the table in Case A. The following table represents the fair value hierarchy table set forth in Topic 820, supplemented to provide information about where in the income statement changes in fair values of assets and liabilities for which the fair value option has been elected are included in earnings. Disclosures required by paragraphs 825-10-50-28(c) and 825-10-50-30(a) are illustrated in the narrative disclosure that follows the table.

<table>
<thead>
<tr>
<th>Description</th>
<th>Fair Value Measurements at December 31, 20X1, Using</th>
<th>Changes in Fair Values for the 12-Month Period Ended December 31, 20X1, for Items Measured at Fair Value Pursuant to Election of the Fair Value Option</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fair Value Measurements</td>
<td>Quoted Prices in Active Markets for Identical Assets (Level 1)</td>
</tr>
<tr>
<td></td>
<td>$ 115</td>
<td>$ 105</td>
</tr>
<tr>
<td>Trading debt securities</td>
<td>75</td>
<td>75</td>
</tr>
<tr>
<td>Available-for-sale debt securities</td>
<td>150</td>
<td>—</td>
</tr>
<tr>
<td>Loans</td>
<td>60</td>
<td>25</td>
</tr>
<tr>
<td>Derivatives</td>
<td>125</td>
<td>50</td>
</tr>
<tr>
<td>Equity investments*</td>
<td>(60)</td>
<td>(40)</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>125</td>
<td>50</td>
</tr>
</tbody>
</table>

(*) Represents investments that would otherwise be accounted for under the equity method of accounting.

Loans are included in loans and lease receivables in the statement of financial position. As of December 31, 20X1, approximately $160,000 of lease receivables are included in loans and lease receivables in the statement of financial position and are not eligible for the fair value option.
**ASC 825-10 (continued)**

55-13 An entity might provide either of the following additional disclosures required by paragraph 825-10-50-28(a) through (b) after the table:

a. Management’s reasons for electing a fair value option for each eligible item or group of similar eligible items

b. If the fair value option is elected for some but not all eligible items within a group of similar eligible items, both of the following:
   1. A description of those similar items and the reasons for partial election
   2. Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position.

### 14.4.12 Guarantors and Collateralizations of Securities

Debt or preferred stock that is registered under the Securities Act of 1933 (the “Securities Act”) may be guaranteed by one or more affiliates of the issuer. Guarantees of registered securities are considered securities themselves under the Securities Act. As a result, both the guaranteed securities and the guarantees of those securities must be registered with the SEC unless they are exempt from registration. Further, a registrant may pledge the capital stock of one or more affiliates as collateral for debt or preferred stock registered under the Securities Act. In the event of a default, the debt holder may enforce the collateral provisions and, as a result, become a holder of the affiliate’s equity.

Regulation S-X requires registrants to disclose certain financial information about (1) guarantors and issuers of guaranteed securities and (2) affiliates whose securities collateralize debt or preferred stock. The requirements are based on the premise that investors in guaranteed debt or collateralized securities rely on the consolidated financial statements of the registrant as their primary source of financial information. Although registration of guaranteed securities under the Securities Act can result in requirements for both the issuer of the guaranteed security and the guarantor of the security to file periodic reports (i.e., Form 10-K and Form 10-Q) in accordance with the Securities Exchange Act of 1934, the SEC has typically provided relief from this requirement for subsidiary issuers and guarantors.

On March 2, 2020, the SEC issued a final rule to amend these requirements. The final rule is generally effective for registration statements first filed on or after January 4, 2021, and for annual reports on Form 10-K or Form 20-F, as applicable, for fiscal years ending after January 4, 2021, and quarterly reports on Form 10-Q for quarterly periods ending after January 4, 2021. Early application is permitted.

Under the new requirements, Regulation S-X, Rule 3-10, allows registrants to provide alternative nonfinancial disclosures and alternative financial disclosures (collectively, the “alternative disclosures”) in lieu of separate financial statements when certain criteria have been met. While Rule 3-10 outlines the eligibility conditions that must be met for a registrant to qualify for the alternative disclosures, the specific disclosure requirements are set forth in Regulation S-X, Rule 13-01. Disclosure requirements for smaller reporting companies are prescribed in Note 3 of Regulation S-X, Rule 8-01.

Regulation S-X, Rule 13-02, requires the registrant to provide “summarized financial information” and other narrative disclosures, to the extent material, of each affiliate whose securities collateralize the securities that are registered or being registered.
Note that if a registered security contains both a guarantee by one or more subsidiaries and a pledge of affiliates’ equity, the registrant must consider the disclosure requirements in both Rule 13-01 and Rule 13-02 because (1) the guarantee and pledge constitute separate credit enhancements and (2) the disclosure requirements for each may be different. As a result, the alternative disclosures necessary for compliance with Rules 13-01 and 13-02 may differ, even if the affiliates whose equity is pledged as collateral and the subsidiaries that guarantee the security are the same entities.

The new rule:

- Replaces the requirement in Rule 3-10 to provide condensed consolidating financial information in the registrant’s financial statements with a requirement to provide alternative financial disclosures (which include summarized financial information of the parent and any issuers and guarantors, as well as other qualitative disclosure) in either the registrant’s MD&A or its financial statements.
- Simplifies the requirements in Rule 3-10 that a parent company must meet to be eligible to provide alternative disclosures rather than full audited financial statements (e.g., by replacing the requirement that a subsidiary issuer or guarantor be 100 percent owned with a requirement that it be consolidated in the parent company’s financial statements).
- Eliminates a registrant’s requirement in Rule 3-10(g) to provide preacquisition financial statements for recently acquired subsidiary issuers and guarantors. However, in certain circumstances, an issuer must provide preacquisition summarized financial information.
- Replaces the requirement in Rule 3-16 to provide separate financial statements for an affiliate that collateralizes a substantial portion of a security with a requirement to provide summarized financial information and other narrative disclosures.
- Reduces the periods for which summarized financial information must be provided to the most recent (1) annual period and (2) year-to-date interim period.
- Relocates the alternative disclosure requirements in Rule 3-10 to the new Rule 13-01 in SEC Regulation S-X.
- Adds to Regulation S-X a new Rule 13-02 that applies to collateralized securities.

A detailed discussion of these requirements is beyond the scope of this Roadmap. For further discussion, see Deloitte’s March 10, 2020, *Heads Up* and Deloitte’s *A Roadmap to SEC Reporting Considerations for Guarantees and Collateralizations*. 
# Chapter 15 — Comparison of U.S. GAAP and IFRS Standards

## 15.1 Background

Under IFRS Standards, accounting requirements related to the issuer's accounting for debt are primarily located in IFRS 9, which addresses recognition, derecognition, and measurement of financial assets and financial liabilities (including derivatives and hedge accounting), and IAS 32, which focuses on the classification of financial instruments (or components thereof) as liabilities or equity and balance sheet offsetting. Further, IAS 1 includes requirements for financial statement presentation and classification of assets and liabilities (including debt) as current or noncurrent. In addition, IFRS 7 addresses the disclosures entities should provide about financial instruments (including debt).

## 15.2 Key Differences

### 15.2.1 Background

The table below summarizes key differences between U.S. GAAP and IFRS Standards related to the issuer's accounting for debt. 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>
<tbody>
<tr>
<td><strong>Interest method — changes in contractual cash flows (Section 15.2.2.1)</strong></td>
<td>There is no broadly applicable guidance on the accounting for changes in estimated contractual cash flows. Prescriptive guidance exists for TDRs and modifications or exchanges that are not accounted for as extinguishments of the original debt.</td>
</tr>
<tr>
<td><strong>Interest method — special accounting for certain debt transactions (Section 15.2.2.2)</strong></td>
<td>Special accounting models apply to certain transactions involving sales of future revenue, participating mortgages, indexed debt, and extendable increasing-rate debt.</td>
</tr>
<tr>
<td><strong>(Table continued)</strong></td>
<td><strong>U.S. GAAP</strong></td>
</tr>
<tr>
<td>------------------------</td>
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</tr>
<tr>
<td><strong>Fair value option — qualifying criteria</strong> <em>(Section 15.2.3.1)</em></td>
<td>The limitations in IFRS Standards on a debtor’s ability to elect the fair value option for a financial liability do not apply under U.S. GAAP.</td>
</tr>
<tr>
<td><strong>Fair value option — fair value changes attributable to credit risk</strong> <em>(Section 15.2.3.2)</em></td>
<td>For financial liabilities for which the fair value option has been elected, fair value changes attributable to instrument-specific credit risk are deferred in OCI and released to earnings upon derecognition of the financial liability.</td>
</tr>
<tr>
<td><strong>Convertible debt — separation of equity component</strong> <em>(see Section 15.2.4)</em></td>
<td>A debtor accounts for convertible debt as a liability in its entirety unless special accounting guidance applies. If the conversion feature does not have to be bifurcated as a derivative liability, recognition of an equity component may be required under special accounting models for convertible debt that (1) can be settled in cash upon conversion, (2) has a BCF at inception or a contingent BCF that has been triggered, (3) was issued at a substantial premium, (4) was modified or exchanged if extinguishment accounting did not apply and the fair value of the conversion feature increased, or (5) has a bifurcated conversion option derivative that was reclassified to equity. Different separation methods are used depending on the applicable accounting model.</td>
</tr>
<tr>
<td><strong>Embedded derivatives — debt with embedded put or call option</strong> <em>(Section 15.2.5.1)</em></td>
<td>A put, call, or prepayment option embedded in a debt contract is considered not clearly and closely related to a debt host contract if (1) it is indexed to an underlying other than interest rates, credit risk, or inflation; (2) the debt involves a substantial discount or premium and the option is contingent; or (3) the option is not contingent and the negative-yield or double-double test is passed.</td>
</tr>
<tr>
<td>Topic</td>
<td>U.S. GAAP</td>
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</tr>
<tr>
<td><strong>Embedded derivatives — debt with embedded equity conversion feature (Section 15.2.5.2)</strong></td>
<td>An equity conversion feature embedded in a debt contract is not bifurcated as a derivative liability if (1) it is considered indexed to the entity's own equity under ASC 815-40-15 and (2) the debtor could not be forced to settle it in cash under ASC 815-40-25. Further, an equity conversion feature is not bifurcated if it must be physically settled and the shares that would be delivered upon conversion are not readily convertible to cash. A down-round protection feature does not affect the assessment. Certain exercise contingencies would preclude a conclusion that a conversion feature is indexed to the entity's own equity.</td>
</tr>
<tr>
<td><strong>Debt extinguishments — expected breakage (Section 15.2.6.1)</strong></td>
<td>An entity derecognizes a financial liability related to a prepaid stored-value product on the basis of expected breakage even if the obligation has not been legally extinguished.</td>
</tr>
<tr>
<td><strong>Debt extinguishments — convertible debt (Section 15.2.6.2)</strong></td>
<td>When convertible debt is extinguished, the accounting for the extinguishment depends on the accounting model that applies to the convertible debt. If the convertible debt can be settled in cash upon conversion and is within the scope of the cash conversion guidance in ASC 470-20, the consideration paid is allocated between the liability and equity components on the basis of the fair value of the liability component. If the convertible debt contains a separately recognized BCF, the consideration generally is allocated on the basis of the current intrinsic value of the conversion option.</td>
</tr>
<tr>
<td><strong>Debt modification or exchange — substantially different terms (Section 15.2.7.1)</strong></td>
<td>The terms of new or modified debt are considered substantially different from the terms of the original debt (such that the original debt is accounted for as being extinguished) if the 10 percent cash flow test is passed, a substantive conversion option is added or removed, or the change in fair value of an embedded conversion option is at least 10 percent of the original carrying amount. This guidance does not apply to TDRs (see below).</td>
</tr>
</tbody>
</table>
### (Table continued)

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Debt modification or exchange — increase in the fair value of an embedded conversion option (Section 15.2.7.2)</strong></td>
<td>If the terms of the new or modified debt are not considered substantially different from the terms of the original debt, the debtor must recognize an increase (but not a decrease) in the fair value of an embedded conversion option in connection with the modification or exchange by reducing the debt's carrying amount with an offset to equity.</td>
</tr>
<tr>
<td><strong>Debt modification or exchange — third-party costs (Section 15.2.7.3)</strong></td>
<td>If the original debt is accounted for as being extinguished, third-party costs are amortized over the life of the new debt by using the interest method. If the new debt is accounted for as a continuation of the original debt, such costs are expensed as incurred.</td>
</tr>
<tr>
<td><strong>Troubled debt restructurings (Section 15.2.8)</strong></td>
<td>A debt modification or exchange is accounted for as a TDR if the creditor grants a concession as a result of the debtor's financial difficulties. Gain recognition is precluded unless the carrying amount exceeds the total amount of the undiscounted future cash flows of the restructured debt.</td>
</tr>
<tr>
<td><strong>Debt conversions — gain or loss recognition (Section 15.2.9)</strong></td>
<td>No gain or loss is recognized upon the conversion of debt into the debtor's equity shares in accordance with the original terms of a conversion feature unless special accounting guidance applies. An extinguishment gain or loss is recognized if (1) conversion occurred upon the debtor's exercise of a call option and the conversion option was not substantive at inception or (2) the convertible debt is within the scope of the guidance on convertible debt that can be settled in cash upon conversion. An expense is recognized for the remaining unamortized discount if the convertible debt contained a separately recognized equity component other than a CCF.</td>
</tr>
<tr>
<td><strong>Balance sheet classification of debt as current or noncurrent— post-balance-sheet-date refinancing (Section 15.2.10.1)</strong></td>
<td>A short-term obligation is classified as noncurrent if it is refinanced on a long-term basis (or a long-term financing arrangement is in place) by the time the financial statements are issued (or available to be issued).</td>
</tr>
</tbody>
</table>
### Continuous Table

<table>
<thead>
<tr>
<th><strong>U.S. GAAP</strong></th>
<th><strong>IFRS Standards</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet classification of debt as current or noncurrent — waivers of covenant violations (Section 15.2.10.2)</td>
<td>A long-term obligation that has become repayable on demand because of a covenant violation as of the balance sheet date is not classified as current if the creditor grants a qualifying waiver before the financial statements are issued (or available to be issued).</td>
</tr>
</tbody>
</table>

### 15.2.2 Interest Method

#### 15.2.2.1 Changes in Contractual Cash Flows

If the timing or amount of the cash flows under a debt contract are modified or vary on the basis of an underlying that does not have to be bifurcated as a derivative, a question arises about how to apply the effective interest method to changes in those contractual cash flows.

Under U.S. GAAP, different methods are appropriate or acceptable for different types of debt transactions (see Sections 6.2.4, 6.2.5, 7.2, 7.3, 7.4, 10.4.3, and 11.4.4). For example, there are three acceptable methods for applying the interest method to sales of future revenue when there are changes to the timing or amount of the estimated future cash flows (see Section 7.2.4). When debt is modified or exchanged and the terms of the modified debt are not substantially different from the terms of the original debt, ASC 470-50 requires the debtor to make a prospective yield adjustment (see Section 10.4.3). When a debt modification or exchange represents a TDR, ASC 470-60 requires the interest rate to be reduced and potentially reset to zero so that a restructuring gain is only recognized if the carrying amount exceeds the total undiscounted future cash flows (see Section 11.4.4).

If an entity revises its estimate of future contractual cash flows of a financial liability (e.g., as a result of a debt modification or exchange that is not accounted for as an extinguishment of the original debt), the entity is required under paragraph B5.4.6 of IFRS 9 to (1) adjust the amortized cost to the present value of the estimated future contractual cash flows discounted by using the liability’s original effective interest rate and (2) recognize the resulting adjustment in profit or loss.

#### 15.2.2.2 Special Accounting for Certain Debt Transactions

Under U.S. GAAP, special accounting models apply to certain transactions involving the sales of future revenue (see Section 7.2), participating mortgages (see Section 7.3), indexed debt (see Section 7.4), and extendable increasing-rate debt (see Section 6.2.4.5). IFRS 9 does not contain similar guidance. Instead, it requires entities to account for such liabilities in a manner similar to other liabilities (i.e., typically at amortized cost by using the interest method).
15.2.3 Fair Value Option

15.2.3.1 Qualifying Criteria

IFRS 9 requires entities to meet certain qualifying criteria before they can elect the fair value option for an otherwise eligible item; there are no such qualifying criteria in ASC 825-10 (see Section 4.4). For financial liabilities, an entity is permitted under paragraph 4.2.2 of IFRS 9 to elect the fair value option when either of the following apply:

- The fair value option “eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.”
- “[A] group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel.”

Further, paragraph 4.3.5 of IFRS 9 permits an entity to elect the fair value option for a financial liability (or other host contract that is not an asset within the scope of IFRS 9) if it contains one or more embedded derivatives unless either of the following conditions is met:

- “[T]he embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract.”
- “[I]t is clear with little or no analysis . . . that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.”

15.2.3.2 Fair Value Changes Attributable to Credit Risk

Under both ASC 825-10 and IFRS 9, changes in the fair value of a financial liability for which the fair value option has been elected are recognized in earnings (profit or loss) except for the portion of the change that is attributable to the liability’s credit risk, which is recognized in OCI (see Section 6.3.2). However, unlike ASC 825-10, paragraph 5.7.8 of IFRS 9 contains an exception under which recognition of the credit risk component through OCI is precluded if it would “create or enlarge an accounting mismatch in profit or loss.”

Upon derecognition of a liability for which fair value changes attributable to the liability’s credit risk have been recognized through OCI, ASC 825-10 requires the credit risk component to be released through earnings (see Section 9.3.2). Under paragraph B5.7.9 of IFRS 9, an entity is not permitted to subsequently release the AOCI component into earnings (or profit or loss) upon derecognition of the liability.

15.2.4 Convertible Debt — Separation of an Equity Component

The issuer of convertible debt is precluded by ASC 470-20 from allocating to equity any of the proceeds received upon its issuance unless a special accounting model applies. If the conversion feature does not have to be bifurcated as a derivative liability under ASC 815-15, recognition of an equity component may be required in accordance with special accounting models for convertible debt that (1) can be settled in cash upon conversion (see Section 7.6.4), (2) has a BCF at inception or a contingent BCF that has been triggered (see Section 7.6.5), (3) was issued at a substantial premium (see Section 7.6.3), (4) was modified or exchanged if extinguishment accounting did not apply and the fair value of the conversion feature increased (see Section 10.4.3.3), or (5) has a bifurcated conversion option derivative that was
reclassified to equity (see Section 8.5.4.3). Different separation methods are used depending on the applicable accounting model. 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; see Chapter 8).

Under paragraph 28 of IAS 32, 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 conditions for equity classification 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).

15.2.5 Embedded Derivatives

15.2.5.1 Debt With Embedded Put or Call Option

Under both ASC 815-15 and IFRS 9, an entity must evaluate put, call, and prepayment features embedded in debt host contracts to determine whether they must be accounted for separately as a derivative. One of the criteria for bifurcation is that the economic characteristics and risks of the embedded feature are not “clearly and closely related” (or, under IFRS 9, simply “closely related”) to those of the host contract (see Section 8.4.4). However, the guidance in each set of standards differs on whether such features are considered clearly and closely related.

In accordance with ASC 815-15, a put, call, or prepayment option that is embedded is not clearly and closely related to a debt host contract if (1) it is indexed to an underlying other than interest rates, credit risk, or inflation (see Section 8.3.2); (2) the debt involves a substantial discount or premium and the option is contingent (see Section 8.4.4); or (3) the option is not contingent and either the negative-yield or double-double test is passed (see Section 8.4.1).

Under paragraph B4.3.5(e) of IFRS 9, a put, call, or prepayment option is not closely related to a debt host contract unless (1) the option’s exercise price is approximately equal to the debt’s amortized cost on each exercise date (before separating any equity component) or (2) a prepayment option’s exercise price “reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract.” Lost interest is computed, as of the prepayment date, as the prepaid principal amount multiplied by the difference between the effective interest rate of the host contract and the effective rate the lender would receive if it reinvested the prepaid principal amount in a similar contract for the remaining term of the host contract.

15.2.5.2 Debt With Embedded Equity Conversion Feature

Under both ASC 815 and IFRS 9, an embedded equity conversion feature is exempt from the requirements for the bifurcation of a derivative if it qualifies as equity. However, the circumstances in which an equity conversion feature qualifies as equity differ. Further, the definition of a derivative differs between ASC 815 and IFRS 9.
In accordance with ASC 815-15, an equity conversion feature embedded in a debt contract qualifies as equity and is exempt from derivative accounting if (1) it is considered indexed to the entity's own equity under ASC 815-40-15 and (2) the debtor could not be forced to settle it in cash underASC 815-40-25 (see Section 8.4.7). A down-round protection feature does not affect the assessment of whether a conversion feature is considered indexed to the entity's own equity (see Section 4.3.7.2 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity). However, exercise contingencies preclude a conclusion that the conversion feature is indexed to the entity's own stock if they are based on an observable market other than the market for the issuer's stock or an observable index other than one calculated or measured solely by reference to the issuer's operations (see Section 4.2 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity).

Under paragraph 10 of IAS 32, an equity conversion feature does not qualify as equity if it can be settled net by either or both parties (e.g., an equity conversion feature that can be settled net in shares). Further, an equity conversion feature does not qualify as equity if it contains down-round protection. However, exercise contingencies do not affect the assessment of whether an equity conversion feature qualifies as equity.

In accordance with ASC 815, an equity conversion feature lacks the net settlement characteristic in the definition of a derivative if it must be physically settled and the shares that would be delivered upon conversion are not readily convertible to cash (e.g., private-company stock). Therefore, such a feature would not be bifurcated under ASC 815-15 even if it does not qualify as equity under ASC 815-40. There is no net settlement requirement under the definition of a derivative in Appendix A of IFRS 9. Accordingly, equity conversion features that are settled in shares that are not readily convertible to cash must be bifurcated if they do not qualify as equity under IAS 32.

15.2.6 Debt Extinguishments

15.2.6.1 Expected Breakage

In accordance with an exception to the extinguishment conditions in ASC 405-20, an entity is required to derecognize a financial liability related to a prepaid stored-value product on the basis of expected breakage even if the obligation has not been legally extinguished (see Section 9.4). Under paragraph 3.3.1 of IFRS 9, a financial liability can only be derecognized when the obligation has been extinguished.

15.2.6.2 Convertible Debt

When convertible debt is extinguished as a result of an early redemption or repurchase, the accounting under U.S. GAAP depends on the model applied to the convertible debt (see Section 9.3.5). If the convertible debt can be settled in cash upon conversion and is within the scope of the cash conversion guidance in ASC 470-20, the consideration paid is allocated between the liability and equity components on the basis of the fair value of the liability component. If the convertible debt contains a separately recognized BCF, the consideration generally is allocated between liabilities and equity on the basis of the current intrinsic value of the conversion option. If the convertible debt is presented as debt in its entirety, no amount is allocated to equity.

Under paragraph AG33 of IAS 32, when convertible debt is extinguished as a result of an early redemption or repurchase, the issuer must allocate the consideration paid between the liability and equity components on the basis of the fair value of the liability component. This treatment does not apply if the conversion feature is bifurcated as a derivative under IFRS 9 (see Section 15.2.5.2).
15.2.7 Debt Modification or Exchange

15.2.7.1 Substantially Different Terms

Under ASC 470-50, the terms of new or modified debt are considered substantially different from the terms of the original debt (such that the original debt is accounted for as being extinguished) if the 10 percent cash flow test is passed (see Section 10.3.3), a substantive conversion option is added or removed (see Section 10.3.4.3), or the change in fair value of an embedded conversion option is at least 10 percent of the original carrying amount (see Section 10.3.4.2). This guidance does not apply to TDRs.

Under IFRS 9, paragraph B.3.3.6 specifies that the terms of new or modified debt are considered substantially different from the terms of the original debt (such that the original debt is accounted for as being extinguished) if the 10 percent cash flow test is passed or, in limited circumstances, the terms are determined to be qualitatively different.

15.2.7.2 Increase in the Fair Value of Embedded Conversion Option

Under ASC 470-50, if the terms of the new or modified debt are not considered substantially different from the terms of the original debt, the debtor must recognize an increase (but not a decrease) in the fair value of an embedded conversion option in connection with the modification or exchange by reducing the debt's carrying amount with an offset to equity (see Section 10.4.3.3). IFRS 9 does not contain any specific guidance on such scenarios. Under IAS 32, conversion features that are recognized in equity are not remeasured.

15.2.7.3 Third-Party Costs

The guidance in ASC 470-50 and IFRS 9 differs on third-party costs incurred in connection with a debt modification or exchange.

If the terms of the new debt are substantially different from the debt's original terms such that the original debt is accounted for as being extinguished, ASC 470-50 requires third-party costs to be amortized over the life of the new debt by using the interest method (see Section 10.4.2). Under paragraph B3.3.6 of IFRS 9, such costs must be expensed as incurred.

If the terms of the new debt are not substantially different from the debt's original terms and the new debt is therefore accounted for as a continuation of the original debt, ASC 470-50 requires third-party costs to be expensed as incurred (see Section 10.4.3). Under paragraph B3.3.6 of IFRS 9, such costs must be amortized over the life of the new debt by using the interest method.

15.2.8 Troubled Debt Restructurings

Under ASC 470-60, a debt modification or exchange is accounted for as a TDR if the creditor grants a concession as a result of the debtor's financial difficulties (see Section 11.3). When TDR accounting applies, the debtor accounts for the effect of the modification to the debt terms prospectively as an adjustment to the effective interest rate, except the effective interest rate cannot be reduced below zero (see Section 11.4.4). The debtor does not recognize a restructuring gain (or corresponding adjustment to the net carrying amount) unless the net carrying amount exceeds the total undiscounted future principal and interest payments of the restructured debt.

IFRS 9 does not contain any special guidance for debt modifications or exchanges that would have been accounted for as TDRs under ASC 470-60. Instead, an entity performs the 10 percent cash flow test to determine whether the modification or exchange should be accounted for as an extinguishment or a continuation of the original debt (see Section 15.2.7.1 above).
15.2.9 Debt Conversions — Gain or Loss Recognition

In accordance with ASC 470-20, no gain or loss is recognized upon the conversion of debt into the debtor's equity shares in accordance with the original terms of a conversion feature unless special accounting guidance applies (see Chapter 12). An extinguishment gain or loss is recognized if (1) conversion occurred upon the debtor's exercise of a call option and the conversion option was not substantive at inception or (2) the convertible debt is within the scope of the guidance on convertible debt that can be settled in cash upon conversion. An expense is recognized for the remaining unamortized discount if the convertible debt contained a separately recognized equity component other than a CCF.

Under paragraph AG32 of IAS 32, no gain or loss is recognized upon a conversion of convertible debt in accordance with the original terms of a conversion feature.

15.2.10 Balance Sheet Classification of Debt as Current or Noncurrent

15.2.10.1 Post-Balance-Sheet-Date Refinancing

Under ASC 470-10, certain short-term obligations (e.g., short-term debt or the currently maturing portion of long-term debt) are classified as noncurrent if the debtor has both the intent and ability to refinance the obligation on a long-term basis (see Section 13.7). To demonstrate an ability to refinance a short-term obligation on a long-term basis, the debtor must either (1) refinance the obligation on a long-term basis after the balance sheet date, but before or as of the date the financial statements are issued or available to be issued, or (2) have a financing agreement that clearly permits it to refinance the obligation on a long-term basis in place before or as of the date the financial statements are issued or available to be issued.

In accordance with paragraph 72 of IAS 1, a debtor classifies a financial liability as current if it is “due to be settled within twelve months after the reporting period” even if the debtor executes an agreement to refinance or reschedule the payments on a long-term basis after the balance sheet date and before the financial statements are authorized for issue.

15.2.10.2 Waivers of Covenant Violations

Under ASC 470-10, a long-term obligation that has become repayable on demand because of a covenant violation as of the balance sheet date is not classified as current if the creditor grants a qualifying waiver before the financial statements are issued (or available to be issued; see Section 13.5.3).

If a debtor has breached a provision of a long-term obligation before the end of the reporting period such that the obligation becomes repayable on demand, paragraph 74 of IAS 1 requires the liability to be classified as current even if the lender agrees, after the end of the reporting period and before the financial statements are authorized for issue, not to demand repayment as a consequence of the breach.
15.3 Additional Information

Other Deloitte Roadmaps contain information about key differences between U.S. GAAP and IFRS Standards related to the accounting for debt. For example, see the guidance in:

- Chapter 9 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.
- Chapter 8 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*.
- Chapter 10 of Deloitte’s *A Roadmap to Distinguishing Liabilities from Equity*.
- Appendix A of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*.
- Appendix B of Deloitte’s *A Roadmap to Fair Value Measurements and Disclosures (Including the Fair Value Option)*.
- Chapter 10 of Deloitte’s *A Roadmap to Foreign Currency Transactions and Translations*.
- Deloitte’s *A Roadmap to Comparing IFRS Standards and U.S. GAAP: Bridging the Differences*. 
Appendix A — Codification Guidance Relevant to Debt

To determine the appropriate treatment of debt under GAAP, an entity must consider the guidance in multiple areas of the Codification, including the following:

<table>
<thead>
<tr>
<th>ASC</th>
<th>Guidance Relevant to Debt</th>
<th>Roadmap Discussion</th>
</tr>
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Appendix B — Glossary of Selected Terms

This appendix contains selected glossary terms from ASC 405-40-20, ASC 470-10-20, ASC 470-20-20, ASC 470-30-20, ASC 470-50-20, ASC 470-60-20, ASC 835-30-20, and the ASC master glossary.

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<th>ASC Master Glossary</th>
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<tr>
<td><strong>Active Market</strong></td>
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<td>A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.</td>
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<tr>
<td><strong>Affiliate</strong></td>
</tr>
<tr>
<td><strong>Definition 1</strong></td>
</tr>
<tr>
<td>A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity. See Control.</td>
</tr>
<tr>
<td><strong>Agent</strong></td>
</tr>
<tr>
<td><strong>Definition 1</strong></td>
</tr>
<tr>
<td>A party that acts for and on behalf of another party. For example, a third-party intermediary is an agent of the transferor if it acts on behalf of the transferor.</td>
</tr>
<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>Auction Rate Notes</strong></td>
</tr>
<tr>
<td>Auction rate notes are notes that generally have long-term nominal maturities and interest rates that reset periodically through a Dutch auction process, typically every 7, 28, or 35 days. At an auction, existing holders of auction rate notes and potential buyers enter a competitive bidding process through a broker-dealer, specifying the number of shares (units) to purchase with the lowest interest rate they are willing to accept. Generally, the lowest bid rate at which all shares can be sold at the notes’ par value establishes the interest rate (also known as the clearing rate) to be applied until the next auction.</td>
</tr>
<tr>
<td><strong>Baby Bonds</strong></td>
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<tr>
<td>See Payment-in-Kind Bonds.</td>
</tr>
<tr>
<td><strong>Basic Earnings per Share</strong></td>
</tr>
<tr>
<td>The amount of earnings for the period available to each share of common stock outstanding during the reporting period.</td>
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## Benchmark Interest Rate
A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions.

In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate.

## Beneficial Conversion Feature
A nondetachable conversion feature that is in the money at the commitment date.

## Beneficial Interests
Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following:

- Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through
- Premiums due to guarantors
- Commercial paper obligations
- Residual interests, whether in the form of debt or equity.

## Bunny Bonds
See Payment-in-Kind Bonds.

## Callable Obligation
An obligation is callable at a given date if the creditor has the right at that date to demand, or to give notice of its intention to demand, repayment of the obligation owed to it by the debtor.

## Capitalization Rate
Rate used to determine amount of interest to be capitalized in an accounting period.

## Capitalize
Capitalize is used to indicate that the cost would be recorded as the cost of an asset. That procedure is often referred to as deferring a cost, and the resulting asset is sometimes described as a deferred cost.

## Carrying Amount
**Definition 1**
For a receivable, the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs and also an allowance for uncollectible amounts and other valuation accounts.

For a payable, the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs.
ASC Master Glossary (continued)

Cash
Consistent with common usage, cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made.

Cash Equivalents
Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

a. Readily convertible to known amounts of cash
b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).

Cash Flow Hedge
A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk.

Cashless Exercise
See Net Share Settlement.

Collateral
Personal or real property in which a security interest has been given.

Collateralized Financing Entity
A variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

Common Stock
A stock that is subordinate to all other stock of the issuer. Also called common shares.
**Conduit Debt Securities**

Certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government's financial reporting entity. Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. Further, the conduit bond obligor is responsible for any future financial reporting requirements.

**Consolidated Financial Statements**

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.

**Consolidated Group**

A parent and all its subsidiaries.

**Contingency**

An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

**Contingently Convertible Instruments**

Contingently convertible instruments are instruments that have embedded conversion features that are contingently convertible or exercisable based on either of the following:

a. A market price trigger
b. Multiple contingencies if one of the contingencies is a market price trigger and the instrument can be converted or share settled based on meeting the specified market condition.

A market price trigger is a market condition that is based at least in part on the issuer's own share price. Examples of contingently convertible instruments include contingently convertible debt, contingently convertible preferred stock, and the instrument described by paragraph 260-10-45-43, all with embedded market price triggers.

**Contract**

An agreement between two or more parties that creates enforceable rights and obligations.

**Contract Asset**

An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

**Contract Liability**

An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.
### ASC Master Glossary (continued)

#### Control

**Definition 1**
The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.

#### Conversion Rate

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. Also called conversion ratio.

####Convertible Security

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).

#### Credit Derivative

A derivative instrument that has both of the following characteristics:

a. 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.

b. 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.

#### Credit Risk

For purposes of a hedged item in a fair value hedge, credit risk is the risk of changes in the hedged item's fair value attributable to both of the following:

a. Changes in the obligor's creditworthiness

b. Changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge.

For purposes of a hedged transaction in a cash flow hedge, credit risk is the risk of changes in the hedged transaction's cash flows attributable to all of the following:

a. Default

b. Changes in the obligor's creditworthiness

c. Changes in the spread over the contractually specified interest rate or the benchmark interest rate with respect to the related financial asset's or liability's credit sector at inception of the hedge.

#### Currency Risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

#### Current Assets

Current assets is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. See paragraphs 210-10-45-1 through 45-4.
Current Liabilities
Current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. See paragraphs 210-10-45-5 through 45-12.

Customer
Definition 1
A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

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.

Diluted Earnings per Share
The amount of earnings for the period available to each share of common stock outstanding during the reporting period and to each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the reporting period.

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. See Premium.

Discount Rate Adjustment Technique
A present value technique that uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows.

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.

Effective Notional Amount
The effective notional amount is the stated notional amount adjusted for any leverage factor.
<table>
<thead>
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<th><strong>ASC Master Glossary (continued)</strong></th>
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<tbody>
<tr>
<td><strong>Embedded Credit Derivative</strong></td>
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<tr>
<td>An embedded derivative that is also a credit derivative.</td>
</tr>
<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>
<tr>
<td><strong>Entry Price</strong></td>
</tr>
<tr>
<td>The price paid to acquire an asset or received to assume a liability in an exchange transaction.</td>
</tr>
<tr>
<td><strong>Equity Kicker</strong></td>
</tr>
<tr>
<td>See Expected Residual Profit.</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>Equity Shares</strong></td>
</tr>
<tr>
<td>Equity shares refers only to shares that are accounted for as equity.</td>
</tr>
<tr>
<td><strong>Error in Previously Issued Financial Statements</strong></td>
</tr>
<tr>
<td>An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.</td>
</tr>
<tr>
<td><strong>Exchange Market</strong></td>
</tr>
<tr>
<td>A market in which closing prices are both readily available and generally representative of fair value. An example of such a market is the New York Stock Exchange.</td>
</tr>
<tr>
<td><strong>Exchange Rate</strong></td>
</tr>
<tr>
<td>The ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time.</td>
</tr>
<tr>
<td><strong>Exercise Contingency</strong></td>
</tr>
<tr>
<td>A provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies.</td>
</tr>
<tr>
<td><strong>Exit Price</strong></td>
</tr>
<tr>
<td>The price that would be received to sell an asset or paid to transfer a liability.</td>
</tr>
<tr>
<td><strong>Expected Cash Flow</strong></td>
</tr>
<tr>
<td>The probability-weighted average (that is, mean of the distribution) of possible future cash flows.</td>
</tr>
</tbody>
</table>
### Expected Residual Profit

The amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by a lender.

### 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.

### Fair Value Hedge

A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk.

### Fed Funds Effective Rate Overnight Index Swap Rate

The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Fed Funds Effective Rate (an overnight rate) with no additional spread over the Fed Funds effective rate on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows.

### Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- a. Receive cash or another financial instrument from a second entity
- b. Exchange other financial instruments on potentially favorable terms with the second entity.

### 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 Master Glossary (continued)

Financial Liability
A contract that imposes on one entity an obligation to do either of the following:
   a. Deliver cash or another financial instrument to a second entity
   b. Exchange other financial instruments on potentially unfavorable terms with the second entity.

Financial Statements Are Available to Be Issued
Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements.

Financial Statements Are Issued
Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP. (U.S. Securities and Exchange Commission [SEC] registrants also are required to consider the guidance in paragraph 855-10-S99-2.)

Financing Activities
Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

Firm Commitment
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.

Forecasted Transaction
A transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.
ASC Master Glossary (continued)

Foreign Currency
A currency other than the functional currency of the entity being referred to (for example, the dollar could be a foreign currency for a foreign entity). Composites of currencies, such as the Special Drawing Rights, used to set prices or denominate amounts of loans, and so forth, have the characteristics of foreign currency.

Foreign Currency Transactions
Transactions whose terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions arise when a reporting entity does any of the following:
   a. Buys or sells on credit goods or services whose prices are denominated in foreign currency
   b. Borrows or lends funds and the amounts payable or receivable are denominated in foreign currency
   c. Is a party to an unperformed forward exchange contract
   d. For other reasons, acquires or disposes of assets, or incurs or settles liabilities denominated in foreign currency.

Foreign Currency Translation
The process of expressing in the reporting currency of the reporting entity those amounts that are denominated or measured in a different currency.

Foreign Entity
An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both:
   a. Prepared in a currency other than the reporting currency of the reporting entity
   b. Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.

Foreign Exchange Risk
The risk of changes in a hedged item's fair value or functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates.

Freestanding Contract
A freestanding contract is entered into either:
   a. Separate and apart from any of the entity's other financial instruments or equity transactions
   b. In conjunction with some other transaction and is legally detachable and separately exercisable.

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.

Functional Currency
An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. (See paragraphs 830-10-45-2 through 830-10-45-6 and 830-10-55-3 through 830-10-55-7.)
ASC Master Glossary (continued)

**Gain Contingency**
An existing condition, situation, or set of circumstances involving uncertainty as to possible gain to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

**High-Yield Debt Securities**
Corporate and municipal debt securities having a lower-than-investment-grade credit rating (BB+ or lower by Standard & Poor’s, or Ba or lower by Moody’s). Because high-yield debt securities typically are used when lower-cost capital is not available, they have interest rates several percentage points higher than investment-grade debt and often have shorter maturities. These high-yielding corporate and municipal debt obligations are frequently referred to as junk bonds.

**Hybrid Instrument**
A contract that embodies both an embedded derivative and a host contract.

**If-Converted Method**
A method of computing EPS data that assumes conversion of convertible securities at the beginning of the reporting period (or at time of issuance, if later).

**Immediate Family**

*Definition 1*
Family members who might control or influence a principal owner or a member of management, or who might be controlled or influenced by a principal owner or a member of management, because of the family relationship.

**Imputed Interest Rate**
The interest rate that results from a process of approximation (or imputation) required when the present value of a note must be estimated because an established exchange price is not determinable and the note has no ready market.

**Income Approach**
Valuation approaches that convert future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

**Inputs**
The assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the following:

a. The risk inherent in a particular valuation technique used to measure fair value (such as a pricing model)
b. The risk inherent in the inputs to the valuation technique.

Inputs may be observable or unobservable.

**In-Substance Defeasance**
Placement by the debtor of amounts equal to the principal, interest, and prepayment penalties related to a debt instrument in an irrevocable trust established for the benefit of the creditor.
Appendix B — Glossary of Selected Terms

**ASC Master Glossary (continued)**

**Interest Cost**
Interest cost includes interest recognized on obligations having explicit interest rates, interest imputed on certain types of payables in accordance with Subtopic 835-30, and interest related to a capital lease determined in accordance with Subtopic 840-30. With respect to obligations having explicit interest rates, interest cost includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

**Note:** The following definition is Pending Content; see Transition Guidance in 842-10-65-1.

Interest cost includes interest recognized on obligations having explicit interest rates, interest imputed on certain types of payables in accordance with Subtopic 835-30, and interest related to a finance lease determined in accordance with Topic 842. With respect to obligations having explicit interest rates, interest cost includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

**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.

**Interest Rate Risk**
For recognized variable-rate financial instruments and forecasted issuances or purchases of variable-rate financial instruments, interest rate risk is the risk of changes in the hedged item’s cash flows attributable to changes in the contractually specified interest rate in the agreement.

For recognized fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item’s fair value attributable to changes in the designated benchmark interest rate. For forecasted issuances or purchases of fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item’s cash flows attributable to changes in the designated benchmark interest rate.

**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. (A nonvested share may be described as an option on that share with an exercise price of zero. Thus, the fair value of a share is the same as the intrinsic value of such an option on that share.)

**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**
The entity that issued a financial instrument or may be required under the terms of a financial instrument to issue its equity shares.

**Issuer’s Equity Shares**
The equity shares of any entity whose financial statements are included in the consolidated financial statements.
ASC Master Glossary (continued)

Junk Bonds
See High-Yield Debt Securities.

Lease
An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

Note: The following definition is Pending Content; see Transition Guidance in 842-10-65-1.

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

Lease Modification
Note: The following definition is Pending Content; see Transition Guidance in 842-10-65-1.

A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

Legal Entity
Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

Level 1 Inputs
Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

Level 2 Inputs
Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 Inputs
Unobservable inputs for the asset or liability.

Liability Issued With an Inseparable Third-Party Credit Enhancement
A liability that is issued with a credit enhancement obtained from a third party, such as debt that is issued with a financial guarantee from a third party that guarantees the issuer's payment obligation.

LIBOR Swap Rate
See London Interbank Offered Rate (LIBOR) Swap Rate.

Line-of-Credit Arrangement
A line-of-credit or revolving-debt arrangement is an agreement that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then reborrow under the same contract. Line-of-credit and revolving-debt arrangements may include both amounts drawn by the debtor (a debt instrument) and a commitment by the creditor to make additional amounts available to the debtor under predefined terms (a loan commitment).
### Loan Commitment

Loan commitments are legally binding commitments to extend credit to a counterparty under certain prespecified terms and conditions. They have fixed expiration dates and may either be fixed-rate or variable-rate. Loan commitments can either be either of the following:

- **Revolving** (in which the amount of the overall line of credit is reestablished upon repayment of previously drawn amounts)
- **Nonrevolving** (in which the amount of the overall line of credit is not reestablished upon repayment of previously drawn amounts).

Loan commitments can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower. Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement. This is not an authoritative or all-encompassing definition.

**Note:** The following definition is Pending Content; see Transition Guidance in 326-10-65-1.

Loan commitments are legally binding commitments to extend credit to a counterparty under certain prespecified terms and conditions. They have fixed expiration dates and may either be fixed-rate or variable-rate. Loan commitments can either be either of the following:

- **Revolving** (in which the amount of the overall commitment is reestablished upon repayment of previously drawn amounts)
- **Nonrevolving** (in which the amount of the overall commitment is not reestablished upon repayment of previously drawn amounts).

Loan commitments can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower. Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement.

### Loan Participation

A transaction in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to groups of banks or other entities.

### Loan Syndication

A transaction in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. It is common for groups of lenders to jointly fund those loans when the amount borrowed is greater than any one lender is willing to lend.

### Local Currency

The currency of a particular country being referred to.

### Lock-Box Arrangement

An arrangement with a lender whereby the borrower's customers are required to remit payments directly to the lender and amounts received are applied to reduce the debt outstanding. A lock-box arrangement refers to any situation in which the borrower does not have the ability to avoid using working capital to repay the amounts outstanding. That is, the contractual provisions of a loan arrangement require that, in the ordinary course of business and without another event occurring, the cash receipts of a debtor are used to repay the existing obligation.
London Interbank Offered Rate (LIBOR) Swap Rate
The fixed rate on a single-currency, constant-notional interest rate swap that has its variable-rate leg referenced to the London Interbank Offered Rate (LIBOR) with no additional spread over LIBOR on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equate to the present value of the variable cash flows.

Long-Term Obligations
Long-term obligations are those scheduled to mature beyond one year (or the operating cycle, if applicable) from the date of an entity's balance sheet.

Loss Contingency
An existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

Make-Whole Provision
Definition 1
A contractual option that gives a debtor (that is, an issuer) the right to pay off debt before maturity at a significant premium over the fair value of the debt at the date of settlement.

Management
Persons who are responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy making functions. Persons without formal titles also may be members of management.

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 Approach
A valuation approach that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.

Market-Corroborated Inputs
Inputs that are derived principally from or corroborated by observable market data by correlation or other means.
**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.

**Market Risk**

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises the following:

a. Interest rate risk

b. Currency risk

c. Other price risk.

**Monetary Assets and Liabilities**

Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash, short- or long-term accounts and notes receivable in cash, and short- or long-term accounts and notes payable in cash.

**Monetary Value**

What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions.

**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 2*

A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain cash equal to the gain.

**Net Income**

A measure of financial performance resulting from the aggregation of revenues, expenses, gains, and losses that are not items of other comprehensive income. A variety of other terms such as net earnings or earnings may be used to describe net income.

**Net Share Settlement**

*Definition 1*

A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain shares of stock with a current fair value equal to the gain.
ASC Master Glossary (continued)

**New Basis Event**
See Remeasurement Event.

**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.

**Nonfinancial Asset**
An asset that is not a financial asset. Nonfinancial assets include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services.

**Nonperformance Risk**
The risk that an entity will not fulfill an obligation. Nonperformance risk includes, but may not be limited to, the reporting entity's own credit risk.

**Nonpublic Entity**

*Definition 1*
Any entity that does not meet any of the following conditions:

a. Its debt or equity securities 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.

b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

d. It is required to file or furnish financial statements with the Securities and Exchange Commission.

e. It is controlled by an entity covered by criteria (a) through (d).

**Not-for-Profit Entity**
An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return

b. Operating purposes other than to provide goods or services at a profit

c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities

b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

**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.
Appendix B — Glossary of Selected Terms

**Obligation**
A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. Because Topic 480 relates only to financial instruments and not to contracts to provide services and other types of contracts, but includes duties or responsibilities to issue equity shares, this definition of obligation differs from the definition found in FASB Concepts Statement No. 6, Elements of Financial Statements, and is applicable only for items in the scope of that Topic.

**Observable Inputs**
Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

**Operating Cycle**
The average time intervening between the acquisition of materials or services and the final cash realization constitutes an operating cycle.

**Operating Activities**
Operating activities include all transactions and other events that are not defined as investing or financing activities (see paragraphs 230-10-45-12 through 45-15). Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

**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).

**Other Comprehensive Income**
Revenues, expenses, gains, and losses that under generally accepted accounting principles (GAAP) are included in comprehensive income but excluded from net income.

**Other Price Risk**
The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer or by factors affecting all similar financial instruments traded in the market.

**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.)

**Participating Interest**
Paragraph 860-10-40-6A defines the term participating interest.

**Participating Security**
A security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not. The form of such participation does not have to be a dividend—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend.
<table>
<thead>
<tr>
<th><strong>ASC Master Glossary (continued)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Participation Rights</strong></td>
</tr>
<tr>
<td>Contractual rights of security holders to receive dividends or returns from the security issuer’s profits, cash flows, or returns on investments.</td>
</tr>
<tr>
<td><strong>Payment-in-Kind Bonds</strong></td>
</tr>
<tr>
<td>Bonds in which the issuer has the option at each interest payment date of making interest payments in cash or in additional debt securities. Those additional debt securities are referred to as baby or bunny bonds. Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds (parent payment-in-kind bonds). Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.</td>
</tr>
<tr>
<td><strong>Payment Provision</strong></td>
</tr>
<tr>
<td>A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.</td>
</tr>
<tr>
<td><strong>Physical Settlement</strong></td>
</tr>
<tr>
<td><strong>Definition 1</strong></td>
</tr>
<tr>
<td>A form of settling a financial instrument under which both of the following conditions are met:</td>
</tr>
<tr>
<td>a. The party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller.</td>
</tr>
<tr>
<td>b. The seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.</td>
</tr>
<tr>
<td><strong>PIK Bonds</strong></td>
</tr>
<tr>
<td>See Payment-in-Kind Bonds.</td>
</tr>
<tr>
<td><strong>Preferred Stock</strong></td>
</tr>
<tr>
<td>A security that has preferential rights compared to common stock.</td>
</tr>
<tr>
<td><strong>Premium</strong></td>
</tr>
<tr>
<td>The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity. See Discount.</td>
</tr>
<tr>
<td><strong>Prepayable</strong></td>
</tr>
<tr>
<td>Able to be settled by either party before its scheduled maturity.</td>
</tr>
<tr>
<td><strong>Present Value</strong></td>
</tr>
<tr>
<td>A tool used to link future amounts (cash flows or values) to a present amount using a discount rate (an application of the income approach). Present value techniques differ in how they adjust for risk and in the type of cash flows they use. See Discount Rate Adjustment Technique.</td>
</tr>
<tr>
<td><strong>Principal Owners</strong></td>
</tr>
<tr>
<td>Owners of record or known beneficial owners of more than 10 percent of the voting interests of the entity.</td>
</tr>
<tr>
<td><strong>Private Company</strong></td>
</tr>
<tr>
<td>An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.</td>
</tr>
</tbody>
</table>
ASC Master Glossary (continued)

Probable

*Definition 2*

The future event or events are likely to occur.

Product Financing Arrangement

A product financing arrangement is a transaction in which an entity sells and agrees to repurchase inventory with the repurchase price equal to the original sale price plus carrying and financing costs, or other similar transactions.

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity’s filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Public Debt Issuance

A public debt issuance occurs when a debtor issues a number of identical debt instruments to an underwriter that sells the debt instruments (in the form of securities) to various investors.

Public Entity

*Definition 2*

An entity that meets any of the following criteria:

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

b. Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market

c. Is controlled by an entity covered by the preceding criteria. That is, a subsidiary of a public entity is itself a public entity.

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.
**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.

**Readily Convertible to Cash**
Assets that are readily convertible to cash have both of the following:

- Interchangeable (fungible) units
- Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

*(Based on paragraph 83(a) of FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises.)*

**Reasonably Possible**
The chance of the future event or events occurring is more than remote but less than likely.

**Reclassification Adjustments**
Adjustments made to avoid double counting in comprehensive income items that are displayed as part of net income for a period that also had been displayed as part of other comprehensive income in that period or earlier periods.

**Registration Payment Arrangement**
An arrangement with both of the following characteristics:

- 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).

- 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).
Related Parties
Related parties include:

- Affiliates of the entity
- 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
- Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
- Principal owners of the entity and members of their immediate families
- Management of the entity and members of their immediate families
- 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
- 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.

Remeasurement Event
A remeasurement (new basis) event is an event identified in other authoritative accounting literature, other than the recognition of an other-than-temporary impairment, that requires a financial instrument to be remeasured to its fair value at the time of the event but does not require that financial instrument to be reported at fair value continually with the change in fair value recognized in earnings. Examples of remeasurement events are business combinations and significant modifications of debt as discussed in paragraph 470-50-40-6.

Note: The following definition is Pending Content; see Transition Guidance in 326-10-65-1.

A remeasurement (new basis) event is an event identified in other authoritative accounting literature, other than the measurement of an impairment under Topic 321 or credit loss under Topic 326, that requires a financial instrument to be remeasured to its fair value at the time of the event but does not require that financial instrument to be reported at fair value continually with the change in fair value recognized in earnings. Examples of remeasurement events are business combinations and significant modifications of debt as discussed in paragraph 470-50-40-6.

Remote
The chance of the future event or events occurring is slight.

Reporting Currency
The currency in which a reporting entity prepares its financial statements.

Reporting Entity
An entity or group whose financial statements are being referred to. Those financial statements reflect any of the following:

- The financial statements of one or more foreign operations by combination, consolidation, or equity accounting
- Foreign currency transactions.
Repurchase Agreement
An agreement under which the transferor (repo party) transfers a financial asset to a transferee (repo counterparty or reverse party) in exchange for cash and concurrently agrees to reacquire that financial asset at a future date for an amount equal to the cash exchanged plus or minus a stipulated interest factor. Instead of cash, other securities or letters of credit sometimes are exchanged. Some repurchase agreements call for repurchase of financial assets that need not be identical to the financial assets transferred.

Repurchase Agreement Accounted for as a Collateralized Borrowing
A repurchase agreement (repo) refers to a transaction in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. A repurchase agreement accounted for as a collateralized borrowing is a repo that does not qualify for sale accounting under Topic 860. The payable under a repurchase agreement accounted for as a collateralized borrowing refers to the amount of the seller-borrower’s obligation recognized for the future repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a reverse repo.

Restatement
The process of revising previously issued financial statements to reflect the correction of an error in those financial statements.

Retrospective Application
The application of a different accounting principle to one or more previously issued financial statements, or to the statement of financial position at the beginning of the current period, as if that principle had always been used, or a change to financial statements of prior accounting periods to present the financial statements of a new reporting entity as if it had existed in those prior years.

Revenue
Definition 1
Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.

Reverse Repurchase Agreement Accounted for as a Collateralized Borrowing
A reverse repurchase agreement accounted for as a collateralized borrowing (also known as a reverse repo) refers to a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances. The receivable under a reverse repurchase agreement accounted for as a collateralized borrowing refers to the amount due from the seller-borrower for the repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a repo.

Right of Setoff
A right of setoff is a debtor’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.

Risk Premium
Compensation sought by risk-averse market participants for bearing the uncertainty inherent in the cash flows of an asset or a liability. Also referred to as a risk adjustment.
**Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate**

The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Secured Overnight Financing Rate (SOFR) (an overnight rate) with no additional spread over SOFR on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows.

**Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate**

The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index with no additional spread over the SIFMA Municipal Swap Index on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows.

**Securitization**

The process by which financial assets are transformed into securities.

**Security**

**Definition 2**

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

- It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

**Set-Off Right**

A common law right of a party that is both a debtor and a creditor to the same counterparty to reduce its obligation to that counterparty if that counterparty fails to pay its obligation.

**Share-Based Payment Arrangements**

An arrangement under which either of the following conditions is met:

- One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.
- The entity incurs liabilities to suppliers that meet either of the following conditions:
  1. The amounts are based, at least in part, on the price of the entity’s shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity’s shares and something other than either the price of the entity’s shares or a market, performance, or service condition.)
  2. The awards require or may require settlement by issuance of the entity’s shares.

The term shares includes various forms of ownership interest 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. Equity shares refers only to shares that are accounted for as equity.

Also called share-based compensation arrangements.
**ASC Master Glossary (continued)**

**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.)

**Short-Term Obligations**
Short-term obligations are those that are scheduled to mature within one year after the date of an entity's balance sheet or, for those entities that use the operating cycle concept of working capital described in paragraphs 210-10-45-3 and 210-10-45-7, within an entity's operating cycle that is longer than one year.

**Spot Rate**
The exchange rate for immediate delivery of currencies exchanged.

**Springing Lock-Box Arrangement**
Some borrowings outstanding under a revolving credit agreement include both a subjective acceleration clause and a requirement to maintain a springing lock-box arrangement, whereby remittances from the borrower's customers are forwarded to the debtor's general bank account and do not reduce the debt outstanding until and unless the lender exercises the subjective acceleration clause.

**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.

**Standstill Agreement**
An agreement signed by the investee and investor under which the investor agrees to limit its shareholding in the investee.

**Step Bonds**
Bonds that involve a combination of deferred-interest payment dates and increasing interest payment amounts over the bond lives and, thus, bear some similarity to zero-coupon bonds and to traditional debentures.

**Stock Dividend**
An issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property that the board of directors deems necessary or desirable to retain in the business. A stock dividend takes nothing from the property of the corporation and adds nothing to the interests of the stockholders; that is, the corporation's property is not diminished and the interests of the stockholders are not increased. The proportional interest of each shareholder remains the same.
ASC Master Glossary (continued)

**Stock Split**
An issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares. Sometimes called a stock split-up.

**Stub Period**
Interest rate swaps with variable rates based on the London Interbank Offered Rate (LIBOR) typically reset at three-month or six-month intervals. Often, swaps may trade on interim dates that do not correspond to a swap reset date. Calendar dates that are swap reset and payment dates are set by market convention. A swap that resets quarterly may have a first payment period that is shorter than a full quarter, such as 30 days versus 90 days. Because the first payment period is not equal to a full quarter, it is referred to as a stub period. That stub period is the period that begins on the date coupon payments begin to accrue and ends on the first payment date.

**Stub Rate**
The stub rate is the variable rate that corresponds to the length of a stub period.

**Subjective Acceleration Clause**
A subjective acceleration clause is a provision in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, if the debtor fails to maintain satisfactory operations or if a material adverse change occurs).

**Subsequent Events**
Events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued. There are two types of subsequent events:

a. The first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements (that is, recognized subsequent events).

b. The second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date (that is, nonrecognized subsequent events).

**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.

**Synthetic Instrument Accounting**
Synthetic instrument accounting views two or more distinct financial instruments (generally a cash instrument and a derivative instrument) as having synthetically created another single cash instrument. The objective of synthetic instrument accounting is to present those multiple instruments in the financial statements as if they were the single instrument that the entity sought to create. Paragraph 815-10-25-4 states that synthetic instrument accounting is prohibited.
ASC Master Glossary (continued)

**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.

**Time of Restructuring**
Troubled debt restructurings may occur before, at, or after the stated maturity of debt, and time may elapse between the agreement, court order, and so forth, and the transfer of assets or equity interest, the effective date of new terms, or the occurrence of another event that constitutes consummation of the restructuring. The date of consummation is the time of the restructuring.

**Time Value of an Option**
The time value of an option is equal to the fair value of an option less its intrinsic value.

**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.)

**Transaction Costs**
The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:

a. They result directly from and are essential to that transaction.

b. They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made (similar to costs to sell, as defined in paragraph 360-10-35-38).

**Transaction Date**
The date at which a transaction (for example, a sale or purchase of merchandise or services) is recorded in accounting records in conformity with generally accepted accounting principles (GAAP). A long-term commitment may have more than one transaction date (for example, the due date of each progress payment under a construction contract is an anticipated transaction date).

**Transaction Gain or Loss**
Transaction gains or losses result from a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated. They represent an increase or decrease in both of the following:

a. The actual functional currency cash flows realized upon settlement of foreign currency transactions

b. The expected functional currency cash flows on unsettled foreign currency transactions.

**Translation**
See Foreign Currency Translation.

**Translation Adjustments**
Translation adjustments result from the process of translating financial statements from the entity's functional currency into the reporting currency.
<table>
<thead>
<tr>
<th><strong>ASC Master Glossary (continued)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Treasury Stock Method</strong></td>
</tr>
<tr>
<td>A method of recognizing the use of proceeds that could be obtained upon exercise of options and warrants in computing diluted EPS. It assumes that any proceeds would be used to purchase common stock at the average market price during the period.</td>
</tr>
<tr>
<td><strong>Troubled Debt Restructuring</strong></td>
</tr>
<tr>
<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>
</tr>
<tr>
<td><strong>Underlying</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Unit of Account</strong></td>
</tr>
<tr>
<td>The level at which an asset or a liability is aggregated or disaggregated in a Topic for recognition purposes.</td>
</tr>
<tr>
<td><strong>Units-of-Revenue Method</strong></td>
</tr>
<tr>
<td>A method of amortizing deferred revenue that arises under certain sales of future revenues. Under this method, amortization for a period is calculated by computing a ratio of the proceeds received from the investor to the total payments expected to be made to the investor over the term of the agreement, and then applying that ratio to the period’s cash payment.</td>
</tr>
<tr>
<td><strong>Unobservable Inputs</strong></td>
</tr>
<tr>
<td>Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.</td>
</tr>
<tr>
<td><strong>Violation of a Provision</strong></td>
</tr>
<tr>
<td>The failure to meet a condition in a debt agreement or a breach of a provision in the agreement for which compliance is objectively determinable, whether or not a grace period is allowed or the creditor is required to give notice of its intention to demand repayment.</td>
</tr>
<tr>
<td><strong>Warrant</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Weather Derivative</strong></td>
</tr>
<tr>
<td>A forward-based or option-based contract for which settlement is based on a climatic or geological variable. One example of such a variable is the occurrence or nonoccurrence of a specified amount of snow at a specified location within a specified period of time.</td>
</tr>
</tbody>
</table>
ASC Master Glossary (continued)

**Working Capital**
Working capital (also called net working capital) is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total entity capital that constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the entity.

**Zero-Coupon Method**
A swap valuation method that involves computing and summing the present value of each future net settlement that would be required by the contract terms if future spot interest rates match the forward rates implied by the current yield curve. The discount rates used are the spot interest rates implied by the current yield curve for hypothetical zero coupon bonds due on the date of each future net settlement on the swap.
Appendix C — Titles of Standards and Other Literature

AICPA Literature

Technical Questions and Answers
Section 1100, “Statement of Financial Position”
  • Section 1100.14, “Classification of Convertible Debt”
Section 3200, “Long-Term Debt”
  • Section 3200.12, “Balance Sheet Classification of Revolving Line of Credit”
  • Section 3200.13, “Uncertainty Arising From Debt Agreement”
  • Section 3200.15, “Disclosure of Five-Year Maturities on Long-Term Debt”
  • Section 3200.17, “Disclosure of Covenant Violation and Subsequent Bank Waiver”
Section 3500, “Commitments”
  • Section 3500.06, “Covenants Imposed by Loan Agreements”
  • Section 3500.07, “Disclosure of Unused Lines of Credit”
Section 4110, “Issuance of Capital Stock”
  • Section 4110.01, “Expenses Incurred in Public Sale of Capital Stock”
  • Section 4110.10, “Costs Incurred in Shelf Registration”
Section 4160, “Contributed Capital”
  • Section 4160.01, “Payment of Corporate Debt by Stockholders”
Section 5200, “Interest Expense”
  • Section 5200.07, “Imputed Interest on Note Exchanged for Cash Only”

FASB Literature

ASC Topics
ASC 210, Balance Sheet
ASC 230, Statement of Cash Flows
ASC 235, Notes to Financial Statements
ASC 250, Accounting Changes and Error Corrections
ASC 260, Earnings per Share
ASC 310, Receivables
ASC 320, Investments — Debt and Equity Securities
ASC 323, Investments — Equity Method and Joint Ventures
ASC 326, Financial Instruments — Credit Losses
ASC 340, Other Assets and Deferred Costs
ASC 405, Liabilities
ASC 410, Asset Retirement and Environmental Obligations
ASC 420, Exit or Disposal Cost Obligations
ASC 430, Deferred Revenue
ASC 440, Commitments
ASC 450, Contingencies
ASC 460, Guarantees
ASC 470, Debt
ASC 480, Distinguishing Liabilities From Equity
ASC 505, Equity
ASC 606, Revenue From Contracts With Customers
ASC 712, Compensation — Nonretirement Postemployment Benefits
ASC 715, Compensation — Retirement Benefits
ASC 718, Compensation — Stock Compensation
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 810, Consolidation
ASC 815, Derivatives and Hedging
ASC 820, Fair Value Measurement
ASC 825, Financial Instruments
ASC 830, Foreign Currency Matters
ASC 835, Interest
ASC 842, Leases
ASC 848, Reference Rate Reform
ASC 850, Related Party Disclosures
ASC 852, Reorganizations
ASC 855, Subsequent Events
ASC 860, Transfers and Servicing
Appendix C — Titles of Standards and Other Literature

ASC 940, Financial Services — Brokers and Dealers
ASC 942, Financial Services — Depository and Lending
ASC 944, Financial Services — Insurance
ASC 960, Plan Accounting — Defined Benefit Pension Plans
ASC 962, Plan Accounting — Defined Contribution Pension Plans
ASC 980, Regulated Operations

ASUs
ASU 2012-04, Technical Corrections and Improvements
ASU 2013-04, Liabilities (Topic 405)
ASU 2015-03, Interest — Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs
ASU 2016-19, Technical Corrections and Improvements
ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers
ASU 2017-11, Earnings Per Share (Topic 260); Distinguishing Liabilities From Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments With Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception
ASU 2018-12, Financial Services — Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts
ASU 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting
ASU 2020-06, 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

Proposed ASUs
No. 2020-900, Reference Rate Reform (Topic 848): Scope Refinement

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)
No. 7, Using Cash Flow Information and Present Value in Accounting Measurements
IFRS Literature
IAS 1, *Presentation of Financial Statements*
IAS 32, *Financial Instruments: Presentation*
IFRS 7, *Financial Instruments: Disclosures*
IFRS 9, *Financial Instruments*

SEC Literature
ASR
No. 268 (FRR Section 211), *Presentation in Financial Statements of “Redeemable Preferred Stocks”*

Codified Financial Reporting Release
Section 211, “Redeemable Preferred Stocks”

Final Rule
No. 33-10762, *Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant’s Securities*

Regulation S-X
Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered”
Rule 3-16, “Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered”
Rule 4-08, “General Notes to Financial Statements”
Rule 5-02, “Balance Sheets”
Rule 6-04, “Balance Sheets”
Rule 7-03, “Balance Sheets”
Rule 8-01, “Preliminary Notes to Article 8”
Rule 9-03, “Balance Sheets”
Rule 13-01, “Guarantors and Issuers of Guaranteed Securities Registered or Being Registered”
Rule 13-02, “Affiliates Whose Securities Collateralize Securities Registered or Being Registered”

SAB Topics
No. 2.A.6, “Debt Issue Costs in Conjunction With a Business Combination”
No. 4.A, “Subordinated Debt”
No. 5.A, “Expenses of Offering”
No. 6.H.2, “Classification of Short-Term Obligations — Debt Related to Long-Term Projects”

Securities Act of 1933
Rule 144, “Selling Restricted and Control Securities”
Securities Exchange Act of 1934
Rule 10b-5, “Employment of Manipulative and Deceptive Practices”
Rule 12b-20, “Additional Information”
Section 13, “Periodical and Other Reports”
Section 15(d), “Registration and Regulation of Brokers and Dealers; Supplementary and Periodic Information”

Superseded Literature

AICPA Accounting Principles Board (APB)
Opinion No. 14, Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants
Opinion No. 26, Early Extinguishment of Debt

AICPA Statement of Position
SOP 97-1, Accounting by Participating Mortgage Loan Borrowers

Derivatives Implementation Group Issue
F6, “Fair Value Hedges: Concurrent Offsetting Matching Swaps and Use of One as Hedging Instrument”

EITF Issues
85-9, “Revenue Recognition on Options to Purchase Stock of Another Entity”
86-28, “Accounting Implications of Indexed Debt Instruments”
90-19, “Convertible Bonds With Issuer Option to Settle for Cash Upon Conversion”
91-2, “Debtor's Accounting for Forfeiture of Real Estate Subject to a Nonrecourse Mortgage”
00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock”
00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments”
02-2, “When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes”
02-4, “Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is Within the Scope of FASB Statement No. 15”
02-15, “Determining Whether Certain Conversions of Convertible Debt to Equity Securities Are Within the Scope of FASB Statement No. 84”
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)”

FASB Implementation Issue
FASB Staff Position

FSP APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)

FASB Statements

No. 6, Elements of Financial Statements
No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings
No. 76, Extinguishement of Debt
No. 78, Classification of Obligations That Are Callable by the Creditor — an amendment of ARB No. 43, Chapter 3A
No. 84, Induced Conversions of Convertible Debt — an amendment of APB Opinion No. 26
No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
No. 133, Accounting for Derivative Instruments and Hedging Activities
No. 150, Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity
No. 155, Accounting for Certain Hybrid Financial Instruments — an amendment of FASB Statements No. 133 and 140
No. 157, Fair Value Measurements

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 D — Abbreviations

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<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>AOCI</td>
<td>accumulated other comprehensive income</td>
</tr>
<tr>
<td>APB</td>
<td>Accounting Principles Board</td>
</tr>
<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
</tr>
<tr>
<td>ARS</td>
<td>auction rate security</td>
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<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
</tr>
<tr>
<td>ASR</td>
<td>SEC Accounting Series Release</td>
</tr>
<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>BCF</td>
<td>beneficial conversion feature</td>
</tr>
<tr>
<td>CCF</td>
<td>cash conversion feature</td>
</tr>
<tr>
<td>CLO</td>
<td>collateralized loan obligation</td>
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<tr>
<td>CoCo</td>
<td>contingently convertible instrument</td>
</tr>
<tr>
<td>CPI</td>
<td>consumer price index</td>
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<tr>
<td>CUSIP</td>
<td>Committee on Uniform Security Identification Procedures</td>
</tr>
<tr>
<td>EBITDA</td>
<td>earnings before interest, taxes, depreciation, and amortization</td>
</tr>
<tr>
<td>EITF</td>
<td>FASB Emerging Issues Task Force</td>
</tr>
<tr>
<td>EPS</td>
<td>earnings per share</td>
</tr>
<tr>
<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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<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>GBP</td>
<td>British pound sterling</td>
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<tr>
<td>HLFV</td>
<td>hypothetical liquidation at fair value</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
</tr>
<tr>
<td>IPO</td>
<td>initial public offering</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
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<tr>
<td>OCA</td>
<td>SEC Office of the Chief Accountant</td>
</tr>
<tr>
<td>OCI</td>
<td>other comprehensive income</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PIK</td>
<td>paid-in-kind</td>
</tr>
<tr>
<td>RPI</td>
<td>retail prices index</td>
</tr>
<tr>
<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
</tr>
<tr>
<td>SAC</td>
<td>subjective acceleration clause</td>
</tr>
<tr>
<td>SBIC</td>
<td>small business investment company</td>
</tr>
<tr>
<td>SD</td>
<td>sum of the digits</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SOFR</td>
<td>Secured Overnight Financing Rate</td>
</tr>
<tr>
<td>SVPP</td>
<td>structured vendor payable program</td>
</tr>
<tr>
<td>SYD</td>
<td>sum-of-the-years' digits</td>
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<tr>
<td>TDR</td>
<td>troubled debt restructuring</td>
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<tr>
<td>VIE</td>
<td>variable interest entity</td>
</tr>
<tr>
<td>USD</td>
<td>U.S. dollar</td>
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