Deloitte.

Technology Industry Accounting Guide

Other Accounting and Financial Reporting Topics: Financial Instruments

March 2023

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. In the United States, Deloitte refers to one or more of the US member firms of DTTL, their related entities that operate using the "Deloitte" name in the United States and their respective affiliates. Certain services may not be available to attest clients under the rules and regulations of public accounting. Please see www.deloitte.com/us/about to learn more about our global network of member firms.

Other Deloitte Publications

Other Deloitte publications, such as our Roadmap Series, are available on the Deloitte Accounting Research Tool (DART), a comprehensive online library of accounting and financial disclosure literature. The Roadmap series includes titles on the following topics:

Business Acquisitions — SEC Reporting Considerations

Business Combinations

Carve-Out Transactions

Comparing IFRS Accounting Standards and U.S. GAAP

Consolidation — Identifying a Controlling Financial Interest

Contingencies, Loss Recoveries, and Guarantees

Contracts on an Entity's Own Equity

Convertible Debt (Before Adoption of ASU 2020-06)

Current Expected Credit Losses

Debt

Distinguishing Liabilities From Equity

Earnings per Share

Environmental Obligations and Asset Retirement Obligations

Equity Method Investees — SEC Reporting Considerations

Equity Method Investments and Joint Ventures

Fair Value Measurements and Disclosures (Including the Fair Value Option)

Foreign Currency Matters

Guarantees and Collateralizations — SEC Reporting Considerations

Hedge Accounting

Impairments and Disposals of Long-Lived Assets and Discontinued Operations

Income Taxes

Initial Public Offerings

Leases

Noncontrolling Interests

Non-GAAP Financial Measures and Metrics

Revenue Recognition

SEC Comment Letter Considerations, Including Industry Insights

Segment Reporting

Share-Based Payment Awards

Statement of Cash Flows

Transfers and Servicing of Financial Assets

Contents

Preface

Contacts

Chapter 1 — 2023 Technology Industry Outlook

Chapter 2 — Revenue Recognition

Chapter 3 — Contract Costs

Chapter 4 — Software and Software-Related Costs

Chapter 5 — Other Accounting and Financial Reporting Topics

Appendix A — Titles of Standards and Other Literature

Appendix B — Abbreviations

Preface

We are pleased to present the inaugural edition of Deloitte's *Technology Industry Accounting Guide* (the "Guide").

The technology industry ecosystem encompasses a wide array of entities, from enterprise software and software-as-a-service (SaaS) providers to hardware and semiconductor manufacturers. The technology industry has also experienced convergence with other types of businesses, creating subsectors such as fintech, health tech, energy tech, education tech, and auto tech, to name a few. Many entities have fueled the significant growth of the technology industry by embracing emerging technologies such as artificial intelligence (AI) and machine learning, everything as a service (XaaS) powered by the cloud, robotics, the Internet of Things (IoT), blockchain, and edge computing. Continuous innovation by technology entities produces novel business models while introducing potentially complex accounting and financial reporting matters.

Finance and accounting professionals in the technology industry face complex issues and must exercise significant judgment in applying existing rules to matters such as revenue recognition, software-related costs, acquisitions and divestitures, consolidation, stock-based compensation, leases, financial instruments, income taxes, digital assets, initial public offerings (IPOs), and disclosures of non-GAAP measures and metrics. To help technology entities work through some of the more difficult accounting and financial reporting issues related to these and other relevant topics, this Guide includes interpretive guidance, illustrative examples, and discussion of recent standard-setting developments (through February 28, 2023).

Appendix A lists the titles of standards and other literature we cited, and Appendix B defines the abbreviations we used.

We hope this Guide is helpful in navigating the various accounting and reporting challenges that technology entities face. We encourage clients to contact their Deloitte team for additional information and assistance.

Contacts

Sandie Kim
National Office Senior Consultation Partner, Accounting and Reporting Services
Technology Deputy Industry Professional Practice Director
Deloitte & Touche LLP
+1 415 783 4848
sandkim@deloitte.com

Michael Wraith
Audit & Assurance Partner
Technology Industry Professional Practice Director
Deputy Managing Partner — Monitoring
Deloitte & Touche LLP
+1 619 237 6552
mwraith@deloitte.com

Dan Le
Audit & Assurance Partner
Technology Deputy Industry Professional Practice Director
Deloitte & Touche LLP
+1 206 716 6015
dle@deloitte.com

Christie Simons
Audit & Assurance Partner
U.S. Audit & Assurance TMT Industry Leader
Global Semiconductor Industry Leader
Deloitte & Touche LLP
+1 415 783 4777
csimons@deloitte.com

Jean-Denis Ncho Oguie
Audit & Assurance Partner
U.S. Audit & Assurance Technology Industry Leader
Deloitte & Touche LLP
+1 415 783 6600
jnchooguie@deloitte.com

Chapter 5 — Other Accounting and Financial Reporting Topics

5.6 Financial Instruments

To fund the cost of operations and the development of new IP and products, technology entities frequently seek external financing. Many of their financing transactions include complex terms and conditions that require a careful accounting analysis. Consequently, technology entities must apply the highly complex, rules-based guidance in U.S. GAAP to determine whether the securities they issue are classified as liabilities, permanent equity, or temporary equity (temporary equity considerations apply to SEC registrants and non-SEC registrants that choose to apply the SEC's rules and guidance). Early-stage and smaller growth technology entities are often financed with preferred stock and warrants with complex and unusual features, whereas larger, more mature entities often have a mix of debt and equity securities with more plain-vanilla common stock capitalization.

An instrument's classification on the balance sheet will affect how returns on the instrument are reflected in an entity's income statement. Returns on liability-classified instruments are reflected in net income (e.g., interest expense or mark-to-market adjustments), whereas returns on equity-classified instruments are generally reflected in equity, without affecting net income. However, dividends and remeasurement adjustments on equity securities that are classified as temporary equity may reduce an entity's reported earnings per share (EPS).

The SEC staff historically has focused on the classification of liabilities and equity on the balance sheet when equity instruments have redemption provisions or financial instruments possess characteristics of both liabilities and equity. For example, classification of convertible debt instruments and freestanding warrants is often scrutinized since they may contain both liability and equity components under U.S. GAAP.

In addition, prospective SEC registrants in the technology industry may have previously outstanding instruments with characteristics of both liabilities and equity at the time they are approaching a potential IPO, or technology entities may issue new instruments in connection with a potential IPO. Even if certain instruments are already outstanding before an IPO, it may be appropriate for an instrument to be classified outside of permanent equity in accordance with SEC rules when public financial statements are initially filed. Further, for a technology entity that becomes a public company, there can be other accounting consequences that did not exist while the entity was private.

The discussion below highlights guidance on the accounting for financial instruments that frequently affects technology entities. The guidance cited is not intended to be all-inclusive or comprehensive; rather, the discussion focuses on targeted considerations related to the application of the guidance most relevant to the industry. To complete an analysis of the accounting for financial instruments, entities must consider all facts and circumstances and use significant judgment.

5.6.1 Liability Classification

Upon the issuance of an equity instrument, a technology entity should first evaluate whether the instrument meets the definition of a liability in accordance with ASC 480. ASC 480 provides guidance on determining whether (1) certain financial instruments with both debt-like and equity-like characteristics should be accounted for "outside of equity" (i.e., as liabilities or, in some cases, assets) by the issuer and (2) SEC registrants should present certain redeemable equity instruments as temporary equity.

Securities issued in the legal form of debt must be classified as liabilities. In addition, ASC 480 requires liability classification for three types of freestanding financial instruments that are not debt in legal form:

- Mandatorily redeemable financial instruments (e.g., mandatorily redeemable preferred stock or mandatorily redeemable noncontrolling interests).
- Obligations to repurchase the entity's equity (e.g., written put options and warrants to issue redeemable equity securities).
- Obligations to issue a variable number of equity shares (e.g., preferred stock that must be settled with a variable number of common shares that have a fixed monetary amount).

For more information, see Deloitte's Roadmap *Distinguishing Liabilities From Equity*.

5.6.2 Redeemable Equity Securities

Technology entities frequently issue redeemable equity securities, such as redeemable preferred stock or redeemable noncontrolling interests. Technology entities may also issue redeemable preferred stock that have substantive conversion options at issuance that would not be considered liabilities under ASC 480 because redemption is not certain, even though such securities are called mandatorily redeemable convertible securities.[1] Further, if redemption is required only upon the liquidation of the entity, the securities are not considered redeemable.

The SEC staff believes that redeemable equity securities are significantly different from conventional equity capital because such securities possess characteristics similar to debt as a result of the redemption obligation attached to the securities. If the instruments are not classified as liabilities, the guidance in ASC 480-10-S99-3A requires instruments to be classified outside of permanent equity in "temporary 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 issuer's control. To determine the appropriate classification, SEC registrants must evaluate all facts and circumstances related to events that could trigger redemption of the securities. Issuers should evaluate whether equity instruments that do not meet the definition of a liability under ASC 480 nevertheless must be presented outside of permanent equity because of any of these provisions. Because only public entities are required to present certain equity instruments as temporary equity (sometimes referred to as mezzanine equity) instead of permanent equity, the SEC staff frequently comments on this topic during the IPO process.

Start-up and other technology entities financed by private equity or venture capital firms often have one or more series of convertible preferred stock issued and outstanding. When holders of convertible preferred stock have control over the entity, the following convertible preferred stock instruments must be classified as temporary equity:

- Convertible preferred stock that contains a stated redemption feature that allows the issuer to call the security on one or more specified dates.

[1] A conversion feature that results in settlement of the instrument through the issuance of a variable number of shares of common stock equal to a fixed monetary amount is equivalent to "share-settled" debt and would not represent a substantive conversion option.

- Convertible preferred stock that contains a stated redemption feature that allows the holder to put the security to the issuer upon the occurrence of a specified event that can be controlled by a vote of the entity's stockholders or by actions of the entity's board of directors.

Even if a convertible preferred stock instrument does not contain a stated redemption feature (i.e., a stated call option or a stated put option), an entity must evaluate the instrument's liquidation provisions, including whether those provisions are considered "ordinary liquidation" or "deemed liquidation" provisions, to determine whether the instrument should be classified as temporary equity. Whereas an ordinary liquidation provision does not trigger the requirement to classify the convertible preferred equity in temporary equity, a deemed liquidation provision will typically trigger the requirement to classify the convertible preferred equity in temporary equity. For example, a deemed liquidation clause that includes the sale or exclusive license of substantially all of a technology entity's IP could require the convertible preferred equity to be classified in temporary equity.

If an instrument classified in temporary equity is currently redeemable, it should be adjusted to its maximum redemption amount as of the balance sheet date. However, if an instrument classified in temporary equity is not currently redeemable and a determination is made that the instrument's redeemability is not probable, subsequent adjustment of the carrying amount is not necessary until it is probable that the security will become redeemable.

For more information, see Chapter 9 of Deloitte's Roadmap *Distinguishing Liabilities From Equity*.

5.6.3 Conversion Features of Preferred Stock and Debt

A technology entity that issues convertible preferred stock or convertible debt should perform an evaluation under ASC 815 to determine whether its contracts contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. If an embedded conversion feature does not need to be bifurcated from the hybrid instrument as an embedded derivative, but the convertible instrument contains beneficial conversion features (BCFs) or may be settled entirely or partially in cash, the instrument may need to be separated into a liability component and an equity component. After concluding that a conversion option does not need to be bifurcated under ASC 815, an issuer should consider whether the cash conversion guidance in ASC 470-20 applies. If the hybrid instrument is not within the scope of the cash conversion guidance, the issuer should consider the BCF guidance in ASC 470-20.

However, after the adoption of ASU 2020-06, an entity will not separately present in equity an embedded conversion feature associated with a cash conversion feature (CCF) or a BCF. Instead, the entity will account for a convertible debt instrument wholly as debt, and for convertible preferred stock wholly as preferred stock (i.e., as a single unit of account), unless (1) a convertible instrument contains features that require bifurcation as a derivative under ASC 815 or (2) a convertible debt instrument was issued at a substantial premium. For an entity that has not yet adopted ASU 2020-06, applying the separation models in ASC 470-20 to convertible instruments with a BCF or CCF involves the recognition of a debt discount, which is amortized to interest expense. The ASU's elimination of these models will reduce reported interest expense and increase reported net income for an entity that issued a convertible instrument that was within the models' scope.

For more information, see Section 7.6 of Deloitte's Roadmap *Issuer's Accounting for Debt*.

5.6.4 Warrants and Debt

A technology entity may also issue both a debt instrument and a warrant on the entity's shares. The entity should consider the definition of a freestanding financial instrument in the ASC master glossary to determine whether the debt instrument and warrant represent freestanding financial instruments. A freestanding financial instrument is 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." When an entity issues debt together with a detachable warrant, and the debt and detachable warrant represent separate freestanding financial instruments, the proceeds received must be allocated between the debt and the warrant. The following table provides an overview of the appropriate allocation of proceeds between debt and detachable warrants at initial recognition:

	Warrant Accounted for at Fair Value, With Fair Value Changes Recognized in Earnings	Warrant Classified as Equity
Debt accounted for at amortized cost	With-and-without method (i.e., warrant is measured initially at fair value and debt is measured as the residual).	Relative fair value method.
Debt accounted for at fair value, with changes in fair value recognized in earnings	If the estimated fair values exceed the proceeds received, special considerations are necessary. 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.	With-and-without method (i.e., debt is measured initially at fair value and warrant is measured as the residual).

For more information, see Sections 3.3.2.1 and 3.4.3.2 of Deloitte's Roadmap *Issuer's Accounting for Debt*.

5.6.5 Accelerated Share Repurchase Programs

Some technology companies have executed accelerated share repurchase (ASR) programs. As described in ASC 505-30-25-5, an ASR program is "a combination of transactions that permits an entity to repurchase a targeted number of shares immediately with the final repurchase price of those shares determined by an average market price over a fixed period of time. An accelerated share repurchase program is intended to combine the immediate share retirement benefits of a tender offer with the market impact and pricing benefits of a disciplined daily open market stock repurchase program."

ASC 505-30 contains unit-of-account guidance for ASR programs. Under ASC 505-30, an entity accounts for an ASR as two separate units of account: a treasury stock repurchase and a separate forward contract on the entity's shares. An entity should analyze the treasury stock repurchase and forward contract separately to determine whether ASC 480 or ASC 815 applies.

For more information, see Section 3.2.5 of Deloitte's Roadmap *Contracts on an Entity's Own Equity*.

5.6.6 Derivatives

Common financing arrangements issued by technology entities in the form of debt or equity capital may be considered to be or may contain equity derivatives (i.e., equity derivatives may be freestanding or embedded). Examples of common equity derivatives are stock warrants, stock options, and forward contracts to buy or sell an entity's shares. Equity derivatives may be classified as liabilities (or, in some cases, as assets) and measured at fair value on the balance sheet, with changes in fair value recognized in earnings. It is important to be aware of these instruments, how they are accounted for, and subsequent events that could affect such accounting. Sometimes, the measurement attribute for such instruments could be fair value as a result of an IPO or subsequent financing.

5.6.6.1 Embedded Derivatives

In addition to the considerations related to freestanding instruments (e.g., warrants or stock options) under ASC 815, an entity should evaluate whether other contracts, such as those involving preferred stock or convertible debt, contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. An entity identifies the terms of each embedded feature on the basis of the feature's economic payoff profile (underlying) rather than on the basis of how the feature has been formally documented. In identifying the embedded features, the entity should consider all terms of the convertible instrument. Common examples of embedded features include conversion options and redemption provisions. For more information, see Chapter 8 of Deloitte's Roadmap *Issuer's Accounting for Debt*.

5.6.6.2 Contracts on an Entity's Own Equity

ASC 815-40 provides guidance on the accounting for contracts (and features embedded in contracts) that are indexed to, and potentially settled in, an entity's own equity (also known as contracts on own equity or equity-linked financial instruments). The analysis under ASC 815-40 can be complex; in performing this analysis, an entity often must consult with its legal counsel regarding the various terms associated with the contract. In general, a contract on an entity's own equity can be classified in equity (and not remeasured while it is classified in equity) as long as it is considered to be indexed to the entity's own stock and the issuer has the ability to settle the contract by issuing its own shares under all scenarios. This determination requires an evaluation of all events that could change the settlement value (e.g., adjustments to strike price) and all events that would affect the form of settlement. For more information, see Deloitte's Roadmap *Contracts on an Entity's Own Equity*.

Many special-purpose acquisition companies (SPACs) issue warrants that must be classified as liabilities because their terms could change depending on the holder. For more information about warrants issued by SPACs and other accounting issues related to SPACs, see Deloitte's October 2, 2020 (updated April 11, 2022), *Financial Reporting Alert*.

Technology entities frequently issue financial instruments that include a provision to adjust the conversion price (other than a standard antidilution provision that applies to all shareholders). For example, an entity may provide certain investors with price protection by adjusting the strike price if there is a subsequent round of equity or convertible instrument financing at a strike price that is lower than theirs. Under a provision that triggers such price protection (a "down-round provision"), the strike price would usually be adjusted to the strike price of the subsequent transaction. Special recognition and measurement requirements apply each time a down-round feature in a freestanding equity-classified instrument is triggered. For more information, see Section 6.1.5 of Deloitte's Roadmap *Contracts on an Entity's Own Equity*.

5.6.7 Fair Value

Many Codification topics require or permit the subsequent measurement of assets or liabilities at fair value. ASC 820-10-35 provides guidance on the subsequent measurement of items at fair value and applies to both recurring and nonrecurring measurements.

The definition of fair value is based on an exit price notion. An asset, liability, or equity instrument is measured at fair value on the basis of market-participant assumptions; such measurement is not entity-specific. Entities must consider all characteristics of the asset, liability, or equity instrument that a market participant would consider in determining an exit price in the principal or most advantageous market.

Technology entities frequently issue securities with restrictions on their sale. In some cases, it is appropriate to consider a restriction on the sale or use of an asset as a characteristic of the asset that affects its fair value. Only a legal or contractual restriction on the sale or use of an asset that is specific to the asset (an instrument-specific restriction) and that would be transferred to market participants should be incorporated into the asset's fair value measurement. Thus, an entity should consider the effect of a restriction on the sale or use of an asset that it owns only if market participants would consider such a restriction in pricing the asset because they would also be subject to the restriction if they acquired the asset. Entity-specific restrictions that would not be transferred to market participants should not be considered in the determination of the asset's fair value, since doing so would be inconsistent with the exit price notion underlying the definition of fair value.

For more information, see Sections 10.1 and 10.2 of Deloitte's Roadmap *Fair Value Measurements and Disclosures (Including the Fair Value Option)*.

5.6.8 Sales of Future Revenue

Technology entities may securitize certain financial assets, such as trade receivables. In those circumstances, entities would apply ASC 860 to determine whether the transfer of financial assets should be accounted for as a sale. However, if an entity cannot recognize accounts receivable because, for example, it does not have an unconditional right to cash, the entity may instead enter into an arrangement that represents a sale of future revenue (i.e., ASC 860 applies only to transfers of recognized financial assets). For more information, see Section 2.2.2 of Deloitte's Roadmap *Transfers and Servicing of Financial Assets*.

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 IP) 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).

Typically, sales of future revenue are within the scope of ASC 470-10. 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.

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
The "form of the transaction is debt"	The transaction purports to be a sale
"The entity has significant continuing involvement in the generation of the cash flows due the investor"	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"	The agreement is not cancelable
"The investor's rate of return is implicitly or explicitly limited by the terms of the transaction"	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"	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"	The agreement includes no guarantees, recourse, or collateral provisions

For more information, see Section 7.2 of Deloitte's Roadmap *Issuer's Accounting for Debt*.

5.6.9 Current Expected Credit Losses

In June 2016, the FASB issued ASU 2016-13 (codified in ASC 326 and subsequently amended), which amends guidance on the impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model (known as the current expected credit loss [CECL] model) that is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses, which is presented as either (1) an offset to the amortized cost basis of the related asset (for on-balance-sheet exposures) or (2) a separate liability (for off-balance-sheet exposures). That is, the expected credit losses estimated over the lifetime of a financial instrument are recognized at inception (i.e., on day 1). While the ASU will not affect technology entities' financial statements as significantly as those of banks, most entities have financial instruments or other assets that are subject to the CECL model once the ASU is adopted. For example, technology entities typically have trade receivables and contract assets. Entities that have yet to adopt the guidance should (1) focus on identifying which financial instruments and other assets are subject to the CECL model and (2) evaluate whether they need to make changes to existing credit impairment models to comply with the new standard. For more information, see Deloitte's Roadmap *Current Expected Credit Losses*.

5.6.10 Reference Rate Reform

In response to the market-wide migration away from the London Interbank Offered Rate (LIBOR) and other interbank offered rates, the FASB issued ASU 2020-04 (with subsequent amendments). The relief provided by the ASU, which is codified in ASC 848, is elective and applies "to all entities, subject to meeting certain criteria, that have contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued because of reference rate reform." The ASU establishes a general contract modification principle that entities can apply in areas of the Codification that may be affected by reference rate reform, as well as (1) elective contract modification expedients for specific areas of the Codification, (2) certain elective hedge accounting expedients, and (3) held-to-maturity debt security classification relief. In December 2022, the FASB issued ASU 2022-06, which defers ASC 848's original sunset date of December 31, 2022, to December 31, 2024. For more information, see Chapter 8 of Deloitte's Roadmap *Hedge Accounting*. The FASB is not acting alone in its efforts to address issues related to reference rate reform. In July 2019, the SEC staff issued a statement that provides additional guidance related to reference rate reform. For more information about the staff's statement, see Deloitte's August 6, 2019, *Heads Up*.

5.6.11 Modification or Exchange of a Freestanding Equity-Classified Written Call Option

In May 2021, the FASB issued ASU 2021-04, which addresses an issuer's accounting for a modification or exchange of a freestanding equity-classified written call option (e.g., warrants) that remains equity classified after the modification or exchange. The guidance clarifies the accounting for the modification or exchange, which is treated in the same manner as if cash had been paid as consideration. The effect of the modification or exchange is measured as the difference between the option's fair value immediately before and immediately after the modification or exchange. For more information, see Section 6.1.4.2 of Deloitte's Roadmap *Contracts on an Entity's Own Equity*.

5.6.12 SEC Comment Letter Trends

5.6.12.1 Debt and Equity

The SEC staff may comment on debt restrictions, including those that limit a registrant's ability to pay dividends or transfer funds within a consolidated group. It is also important for a registrant to consider providing disclosures about debt covenant compliance in MD&A to illustrate its financial condition and liquidity.

The SEC staff has asked registrants to explain the basis for their determination of how financial instruments should be classified and their application of relevant accounting literature (e.g., ASC 480, ASC 815), particularly for financial instruments that have both debt- and equity-like characteristics. In addition, the SEC staff frequently asks registrants with redeemable securities — including registrants undertaking IPO transactions — to support the basis for their classification of such securities as debt, temporary (mezzanine) equity, or permanent equity. Further, the staff often asks registrants about the accounting for conversion features in convertible instruments, including convertible preferred securities.

For more information, see Sections 2.4 and 2.8 of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.6.12.2 Earnings per Share

When a filing indicates that the registrant has two classes of common stock (or one class of common stock and participating securities) that have been treated as a single class in the calculation of EPS, the SEC staff often asks whether application of the two-class method in the computation of EPS under ASC 260-10-45-59A through 45-70 is required. The SEC staff may ask a registrant to substantiate the method used to calculate EPS (e.g., the two-class method or the if-converted method), and it may request additional information or disclosures about each of the registrant's classes of common stock, preferred stock, and common-stock equivalents (such as convertible securities, warrants, or options). Further, the SEC staff expects that a registrant with two classes of common stock will present both basic and diluted EPS for each class regardless of whether either class has conversion rights.

For more information, see Section 2.6 of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.6.12.3 Fair Value

The SEC staff has requested more specific information from registrants related to valuation techniques and inputs used in fair value measurements. Registrants should consider how the fair value disclosure requirements of ASC 820-10-50 apply to their recurring and nonrecurring fair value measurements. More specifically, registrants should provide information about (1) the methods and techniques used to determine fair value and (2) the inputs to those models. In addition, entities are required to disclose quantitative information about the significant unobservable inputs used in Level 3 fair value measurements.

The SEC staff continues to ask registrants to describe the procedures they perform to validate fair value measurements obtained from third-party pricing services. The staff has also asked registrants to clarify when and how often they use adjusted rather than unadjusted quoted market prices and to disclose why prices obtained from pricing services and securities dealers were adjusted. If multiple quotes were obtained, the SEC staff may request information about how the registrant determined the ultimate value used in the financial statements.

For more information, see Section 2.7 of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.6.12.4 Embedded Derivatives

The SEC staff may ask whether registrants have reached appropriate accounting conclusions regarding whether embedded features in hybrid instruments should be bifurcated from the host contract. Given the complexity involved in determining whether a host contract is debt-like or equity-like, registrants can expect the SEC staff to continue asking about the terms and features of convertible instruments to determine whether the registrant has (1) properly determined the nature of the host contract and (2) accounted for embedded features as stand-alone financial instruments when necessary. Registrants should consider the disclosure requirements of ASC 815-15 when making disclosures about the nature of the host contract.

For more information, see Section 2.8.1 of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

Appendix A — Titles of Standards and Other Literature

AICPA Literature

Accounting and Valuation Guide

Valuation of Privately-Held-Company Equity Securities Issued as Compensation

Audit and Accounting Guide

Revenue Recognition

Practice Aid

Accounting for and Auditing of Digital Assets

FASB Literature

ASC Topics

ASC 205, *Presentation of Financial Statements*

ASC 210, *Balance Sheet*

ASC 235, *Notes to Financial Statements*

ASC 260, *Earnings per Share*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 310, *Receivables*

ASC 320, *Investments — Debt Securities*

ASC 321, *Investments — Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 325, *Investments — Other*

ASC 326, *Financial Instruments — Credit Losses*

ASC 330, *Inventory*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 450, *Contingencies*

ASC 460, *Guarantees*

ASC 470, *Debt*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 505, *Equity*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 705, *Cost of Sales and Services*

ASC 710, *Compensation — General*

ASC 712, *Compensation — Nonretirement Postemployment Benefits*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 730, *Research and Development*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 808, *Collaborative Arrangements*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 820, *Fair Value Measurement*

ASC 825, *Financial Instruments*

ASC 840, *Leases*

ASC 842, *Leases*

ASC 845, *Nonmonetary Transactions*

ASC 848, *Reference Rate Reform*

ASC 860, *Transfers and Servicing*

ASC 940, *Financial Services — Brokers and Dealers*

ASC 944, *Financial Services — Insurance*

ASC 946, *Financial Services — Investment Companies*

ASC 985, *Software*

ASUs

ASU 2014-01, *Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

ASU 2016-08, *Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*

ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*

ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers*

ASU 2018-07, *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*

ASU 2018-11, *Leases (Topic 842): Targeted Improvements*

ASU 2018-15, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract* — a consensus of the FASB Emerging Issues Task Force

ASU 2019-08, *Compensation — Stock Compensation (Topic 718) and Revenue From Contracts With Customers (Topic 606): Codification Improvements — Share-Based Consideration Payable to a Customer*

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*

ASU 2021-02, *Franchisors — Revenue From Contracts With Customers (Subtopic 952-606): Practical Expedient*

ASU 2021-04, *Earnings per Share (Topic 260), Debt — Modifications and Extinguishments (Subtopic 470-50), Compensation — Stock Compensation (Topic 718), and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options* — a consensus of the FASB Emerging Issues Task Force

ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities From Contracts With Customers*

ASU 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*

Concepts Statements

No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

No. 8, *Conceptual Framework for Financial Reporting — Chapter 4,* Elements of Financial Statements

Proposed ASU

No. 2022-ED300, *Business Combinations — Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*

IRC

Section 382, "Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change"

Section 409A, "Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans"

IFRS Literature

IFRS 15, *Revenue From Contracts With Customers*

IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*

SEC Literature

FRM

Topic 7, "Related Party Matters"

Topic 10, "Emerging Growth Companies"

Interpretive Release

No. 33-10751, *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations*

Regulation S-K

Item 10(e), "General; Use of Non-GAAP Financial Measures in Commission Filings"

Item 103, "Business; Legal Proceedings"

Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

Regulation S-X

Rule 3-13, "Filing of Other Financial Statements in Certain Cases"

Rule 5-03, "Statements of Comprehensive Income"

Rule 11-01, "Presentation Requirements"

SAB Topics

No. 1, "Financial Statements"

- No. 1.B, "Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity"
- No. 1.M, "Materiality"

No. 5.Y, "Miscellaneous Accounting; Accounting and Disclosures Relating to Loss Contingencies"

Securities Exchange Act of 1934

Section 13, “Periodical and Other Reports”

Section 15(d), “Registration and Regulation of Brokers and Dealers; Supplementary and Periodic Information”

Superseded Literature

AICPA Technical Practice Aid

Section 5100.68, “Revenue Recognition: Fair Value of PCS in Perpetual and Multi-Year Time-Based Licenses and Software Revenue Recognition”

EITF Abstract

Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*

FASB Concepts Statement

No. 6, *Elements of Financial Statements* — a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

Other Literature

FASB TRG Agenda Papers

TRG Agenda Paper 23, *Incremental Costs of Obtaining a Contract*

TRG Agenda Paper 41, *Measuring Progress When Multiple Goods or Services Are Included in a Single Performance Obligation*

TRG Agenda Paper 44, *July 2015 Meeting — Summary of Issues Discussed and Next Steps*

TRG Agenda Paper 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*

TRG Agenda Paper 59, *Payments to Customers*

TRG Agenda Paper 60, *November 2016 Meeting — Summary of Issues Discussed and Next Steps*

Appendix B — Abbreviations

Abbreviation	Description
AI	artificial intelligence
AICPA	American Institute of Certified Public Accountants
ASC	FASB Accounting Standards Codification
ASR	accelerated share repurchase
ASU	FASB Accounting Standards Update
BC	Basis for Conclusions
BCF	beneficial conversion feature
C&DI	SEC Compliance and Disclosure Interpretation
CAM	critical audit matter
CAQ	Center for Audit Quality
CCF	cash conversion feature
CECL	current expected credit loss
CIMA	Chartered Institute of Management Accountants
CPM	cost per mille
CRM	customer relationship management
DLOM	discount for lack of marketability
DTA	deferred tax asset
DTL	deferred tax liability
EBITDA	earnings before interest, taxes, depreciation, and amortization
EDGAR	SEC's Electronic Data Gathering, Analysis, and Retrieval System
EGC	emerging growth company
EITF	FASB Emerging Issues Task Force
EPS	earnings per share

Abbreviation	Description
ERP	enterprise resource planning
ex-TAC	excluding traffic acquisition costs
Exchange Act	Securities Exchange Act of 1934
FASB	Financial Accounting Standards Board
FAST Act	Fixing America's Surface Transportation Act
FIFO	first in, first out
FinREC	AICPA Financial Reporting Executive Committee
FRM	SEC Financial Reporting Manual
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IC	independent contractor
ICFR	internal control over financial reporting
IFRS	International Financial Reporting Standard
IoT	Internet of Things
IP	intellectual property
IPO	initial public offering
IPR&D	in-process research and development
IRC	Internal Revenue Code
IT	information technology

Abbreviation	Description
JOBS Act	Jumpstart Our Business Startups Act
KPI	key performance indicator
LIBOR	London Interbank Offered Rate
LIFO	last in, first out
LLC	limited liability company
M&A	merger and acquisition
MD&A	Management's Discussion and Analysis
NFT	nonfungible token
NOL	net operating loss
OCA	SEC's Office of the Chief Accountant
OEM	original equipment manufacturer
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCS	postcontract customer support
Q&A	question and answer
R&D	research and development
RMN	retail media network
ROU	right-of-use

Abbreviation	Description
S&P 500	Standard & Poor's 500 stock market index
SaaS	software as a service
SAB	SEC Staff Accounting Bulletin
Sarbanes-Oxley	Sarbanes-Oxley Act of 2002
SEC	U.S. Securities and Exchange Commission
Securities Act	Securities Act of 1933
SG&A	selling, general, and administrative
SKU	separate stock-keeping unit
SPAC	special-purpose acquisition company
SRC	smaller reporting company
SSP	stand-alone selling price
TMT	Technology, Media, & Telecommunications
TPA	AICPA Technical Practice Aid
TRG	FASB/IASB transition resource group for revenue recognition
VIE	variable interest entity
XaaS	everything as a service

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

The services described herein are illustrative in nature and are intended to demonstrate our experience and capabilities in these areas; however, due to independence restrictions that may apply to audit clients (including affiliates) of Deloitte & Touche LLP, we may be unable to provide certain services based on individual facts and circumstances.

The *FASB Accounting Standards Codification*® material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116, and is reproduced with permission.

Copyright © 2023 Deloitte Development LLC. All rights reserved.