Distinguishing Liabilities from Equity (Including Convertible Debt)

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July 23, 2019

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Background

- High volume of SEC comment letters
- Leading cause of financial statement restatements

Stakeholder Feedback on Guidance

- Complex
- Difficult to navigate
- Rules-based and path dependent
- Internally inconsistent
Project Objectives

Reduce cost and complexity in financial reporting

- Convertible instruments *(Primarily Topic 470-20)*
- Derivatives scope exception for contracts in an entity’s own equity *(Subtopic 815-40)*
  - Indexation criterion (formerly EITF Issue 07-5)
  - Equity classification (settlement) criterion (formerly EITF Issue 00-19)

Maintain or improve the quality of information reported to financial statement users.
Project Timeline

September 2017
Project added to the agenda

June 2018
Board decisions: convertible instruments

February 2019
Board decisions: convertible instruments disclosures, derivatives scope exception, EPS

1st Half 2019
Completed Initial Deliberations

2nd Half 2019
Exposure Draft projected to be Issued

Stakeholder outreach
Convertible Instruments
# Convertible Debt

## Current GAAP: Five Models

<table>
<thead>
<tr>
<th>Model</th>
<th>Host Instrument</th>
<th>Conversion Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Embedded Derivative</td>
<td>Residual (liability)</td>
<td>Fair Value (liability)</td>
</tr>
<tr>
<td>2) Cash Conversion</td>
<td>Fair Value w/o conversion option (liability)</td>
<td>Residual (equity)</td>
</tr>
<tr>
<td>3) Beneficial Conversion Feature</td>
<td>Residual (liability)</td>
<td>Intrinsic Value (equity)</td>
</tr>
<tr>
<td>4) Substantial Premium</td>
<td>Residual (liability)</td>
<td>Premium (equity)</td>
</tr>
<tr>
<td>5) Traditional Convertible Debt</td>
<td>No separation – entire instrument carried at amortized cost (liability)</td>
<td></td>
</tr>
</tbody>
</table>

## Future GAAP: Two Models

- Embedded Derivative
- Traditional Convertible Debt

## Objective: Simplification
# Convertible Preferred Shares

## Current GAAP: Four Models

<table>
<thead>
<tr>
<th>Model</th>
<th>Host Instrument</th>
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<tr>
<td>1) Embedded Derivative</td>
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<tr>
<td>2) Beneficial Conversion Feature</td>
<td>Residual (equity)</td>
<td>Intrinsic Value (equity)</td>
</tr>
<tr>
<td>3) Traditional Convertible Preferred Shares</td>
<td>No separation – entire instrument carried at historical cost (equity)</td>
<td></td>
</tr>
<tr>
<td>4) Mandatorily Redeemable Preferred Shares</td>
<td>Accounted for as convertible debt with cash conversion feature</td>
<td></td>
</tr>
</tbody>
</table>

## Future GAAP: Three Models

- Embedded Derivative
- Traditional Convertible Preferred Shares
- Traditional Convertible Debt

**Objective:** Simplification
Overall Proposed Changes

- Simplification of accounting for convertible instruments
- Number of convertible instrument models
- Bifurcation of conversion options
Convertible Instruments: Basis for Conclusions

- Feedback from financial statement users is that they generally view and analyze convertible instruments on a whole-instrument basis
  - Current separation models are neither useful nor relevant
  - Cash (coupon) interest expense, rather than an imputed interest expense (for example, the borrowing cost of a similar debt without conversion features), is more relevant information for their analyses
  - Most users prefer a clean and consistent starting point across entities to perform their analyses

- Reduce complexity in accounting for convertible instruments and the difficulties with interpretation and application of the multiple accounting models
Derivatives Scope Exception
Derivatives Scope Exception

- Under Section 815-40-15, an entity must determine whether a contract meets a scope exception from derivative accounting. The guidance must be applied to:
  - Freestanding financial instruments or embedded features that have all the characteristics of derivative instruments
  - Freestanding financial instruments that potentially are settled in an entity’s own stock, regardless of whether the instrument has all the characteristics of a derivative instrument.
Consequences of the Derivatives Scope Exception

<table>
<thead>
<tr>
<th>Freestanding financial instruments</th>
<th>Embedded features</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fail the scope exception</strong></td>
<td><strong>Fail the scope exception</strong></td>
</tr>
<tr>
<td>- Liability classification as a derivative</td>
<td>- Bifurcation from the host contract and liability classification as a derivative</td>
</tr>
<tr>
<td>- Remeasured every period at fair value through net income</td>
<td>- Remeasured every period at fair value through net income</td>
</tr>
<tr>
<td>- Topic 815 disclosures</td>
<td></td>
</tr>
<tr>
<td><strong>Pass the scope exception</strong></td>
<td><strong>Pass the scope exception</strong></td>
</tr>
<tr>
<td>- Equity classification</td>
<td>- No bifurcation from the host contract (either as liability or equity)</td>
</tr>
<tr>
<td>- No remeasurement</td>
<td>- No separate accounting</td>
</tr>
<tr>
<td>- Subtopic 815-40 / Topic 505 disclosures</td>
<td></td>
</tr>
</tbody>
</table>
Current GAAP

Probability cannot be factored in when evaluating the criteria.

Indexation Criterion
- Will the instrument or feature settle in a fixed number of shares at a fixed price?
- 20 illustrative examples applied by analogy

Equity Classification Criterion (Settlement)
- Does the entity have the ability to share settle the instrument or feature?
- 7 additional conditions for equity classification

Reassessment at every reporting period.
**Future GAAP**

*Do not evaluate contingent events that are remote of occurring.*

**Indexation Criterion**
- Will the instrument or feature settle in a fixed number of shares at a fixed price?
- 20 illustrative examples applied by analogy

**Equity Classification Criterion (Settlement)**
- Does the entity have the ability to share settle the instrument or feature?
- 4 additional conditions for equity classification

*Reassessment only upon triggering events*.  

*Likelihood of remote events should not be reassessed.*
Overall Proposed Changes

- Use of management’s judgment
- Strict rules
- Form over substance classification outcomes
Derivatives Scope Exception: Basis for Conclusions

- Increase understandability of the guidance and the subsequent accounting conclusions by all stakeholders
  - Reduce form over substance classification conclusions that are driven by remote contingent events

- Provides immediate relief for private companies and small public companies that continue to have errors in their financial statements because of the strict accounting requirements
  - Least costly approach to implement since it leverages the current guidance
Disclosures and Earnings Per Share (EPS)
Disclosures

- Reviewed current disclosures for convertible instruments and contracts in an entity’s own equity
- Most users thought the current disclosures provided sufficient information for their analyses
  - The Board decided on minor changes based on user feedback, such as:
    • Conditions that affect conversion
    • Party that controls the conversion option
    • Triggering events that could cause a reclassification
# Effect of Conversion on EPS

## Scope
- Convertible debt with the principal settled in cash and premium settled in cash or shares (so called “Instrument C”)
- All other convertible debt
- Convertible preferred shares

## Diluted EPS

<table>
<thead>
<tr>
<th>Numerator</th>
<th>“If Converted” Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>No adjustment made</td>
<td>Add back interest and dividends</td>
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<table>
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<tr>
<th>Denominator</th>
<th>“If Converted” Method</th>
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</thead>
<tbody>
<tr>
<td>Adjust for additional shares calculated by the following formula: ( \frac{(Average \ Share \ Price - Strike \ Price) \times Conversion \ Ratio}{Average \ Share \ Price} )</td>
<td>Adjust for the additional shares issuable upon the assumed conversion as of the beginning of the year</td>
</tr>
</tbody>
</table>

**Note:** The “If Converted” Method is applied only to diluted EPS in situations in which the securities would be dilutive. If the conversion would be anti-dilutive, the conversion would be ignored. Contingently convertible instruments are included in diluted EPS regardless of whether the contingency has been achieved.
## Future EPS for Convertible Instruments

### Effect of Conversion on EPS

<table>
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<th>“If Converted” Method</th>
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<tr>
<td>Scope</td>
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<tr>
<td>• All convertible instruments</td>
</tr>
<tr>
<td>Numerator</td>
</tr>
<tr>
<td>Add back interest and dividends.</td>
</tr>
<tr>
<td>For convertible debt where the principal is required to be paid in cash, the interest shall not be added back to the numerator.</td>
</tr>
<tr>
<td>Denominator</td>
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<tr>
<td>Adjust for the additional shares issuable upon the assumed conversion as of the beginning of the year.</td>
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<tr>
<td>Clarify that average share price should be used to calculate the potential dilution.</td>
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*Note: The “If Converted” Method is applied only to diluted EPS in situations in which the securities would be dilutive. If the conversion would be anti-dilutive, the conversion would be ignored. Contingently convertible instruments are included in diluted EPS regardless of whether the contingency has been achieved.*
Instruments Settled in Cash or Shares

**Current GAAP**

Entity can rebut the presumption that an instrument will share settle when they control the settlement method.

**Future GAAP**

Always assume share settlement for instruments when the entity controls the settlement method.

- Remove entity’s ability to claim cash settlement.

Applies to convertible instruments and other equity-linked financial instruments.
Diluted EPS: Basis for Conclusions

- Focus on the consequences of the amendments in the proposed Update to convertible instruments and contracts in an entity’s own equity
  - Not a holistic review of the EPS guidance

- Improve the consistency of EPS calculations
  - Align the diluted EPS calculation for convertible instruments in response to the Board’s decision to align the recognition and measurement guidance for convertible instruments
  - Simplify the application of diluted EPS guidance for instruments that may be settled in cash or shares
Questions for the Boards

- Would Board members like any additional information about the FASB’s tentative decisions?
- Do Board members have any feedback about the FASB’s tentative decisions?