



Distinguishing Liabilities from Equity (Including Convertible Debt)

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Background

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



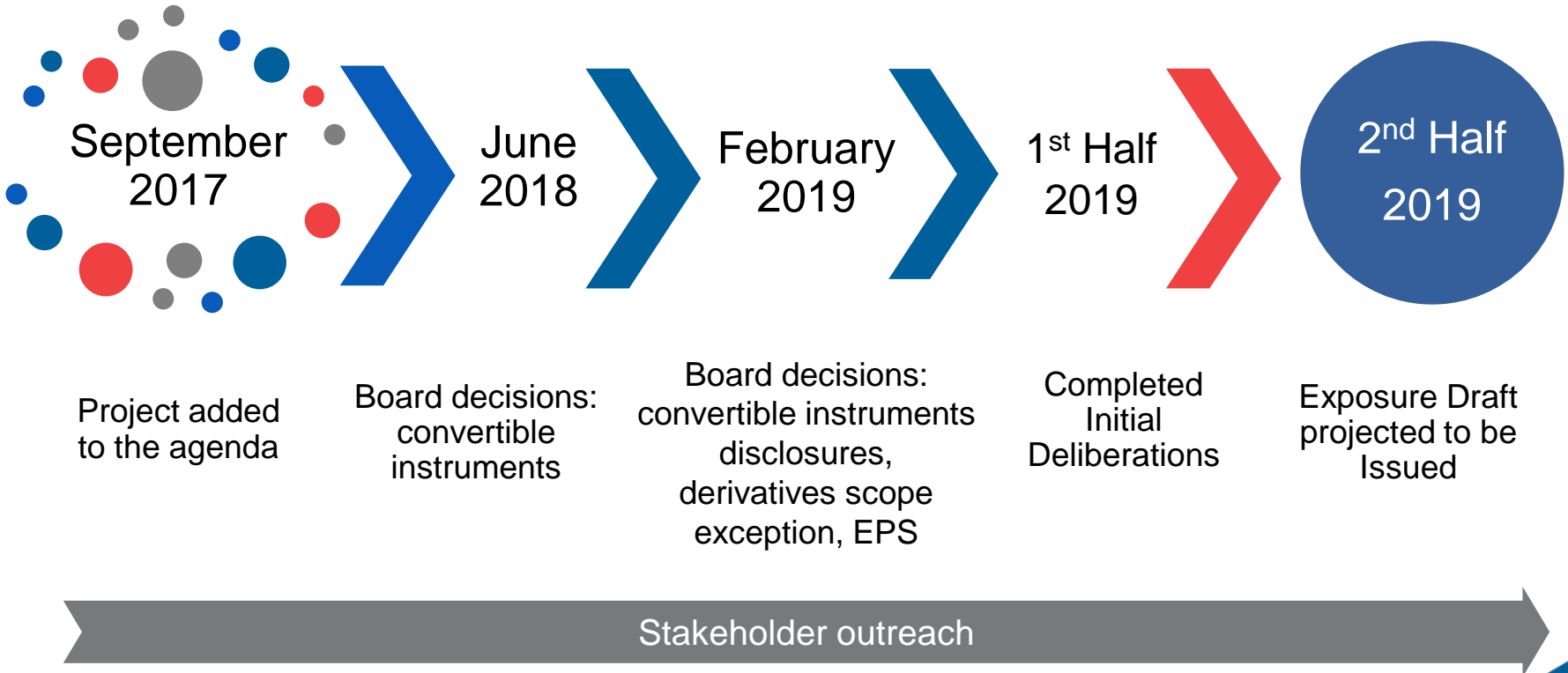
Project Objectives

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



Convertible Instruments

Convertible Debt

Current GAAP: Five Models			Future GAAP: Two Models
	<u>Initial Measurement Attribute</u>		
<u>Model</u>	<u>Host Instrument</u>	<u>Conversion Option</u>	
1) Embedded Derivative	Residual (liability)	Fair Value (liability)	Embedded Derivative
2) Cash Conversion	Fair Value w/o conversion option (liability)	Residual (equity)	Traditional Convertible Debt
3) Beneficial Conversion Feature	Residual (liability)	Intrinsic Value (equity)	
4) Substantial Premium	Residual (liability)	Premium (equity)	
5) Traditional Convertible Debt	No separation – entire instrument carried at amortized cost (liability)		

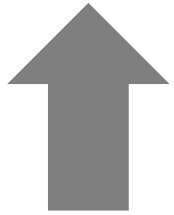
Objective: Simplification

Convertible Preferred Shares

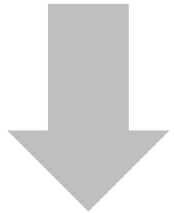
Current GAAP: Four Models				Initial Measurement Attribute		Future GAAP: Three Models
Model	Host Instrument	Conversion Option				
1) Embedded Derivative	Residual (equity)	Fair Value (liability)	→		Embedded Derivative	
2) Beneficial Conversion Feature	Residual (equity)	Intrinsic Value (equity)	}		Traditional Convertible Preferred Shares	
3) Traditional Convertible Preferred Shares	No separation – entire instrument carried at historical cost (equity)					
4) Mandatorily Redeemable Preferred Shares	Accounted for as convertible debt with cash conversion feature		→		Traditional Convertible Debt	

Objective: Simplification

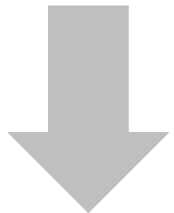
Overall Proposed Changes



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

	Freestanding financial instruments	Embedded features
Fail the scope exception	<ul style="list-style-type: none"> • Liability classification as a derivative • Remeasured every period at fair value through net income • Topic 815 disclosures 	<ul style="list-style-type: none"> • Bifurcation from the host contract and liability classification as a derivative • Remeasured every period at fair value through net income
Pass the scope exception	<ul style="list-style-type: none"> • Equity classification • No remeasurement • Subtopic 815-40 / Topic 505 disclosures 	<ul style="list-style-type: none"> • No bifurcation from the host contract (either as liability or equity) • No separate accounting

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

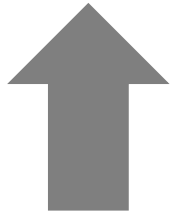
Equity
Classification
Criterion
(Settlement)

- Does the entity have the ability to share settle the instrument or feature?
- 4 additional conditions for equity classification

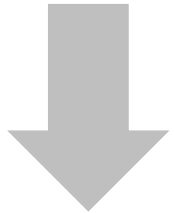
Reassessment only upon triggering events*.

***Likelihood of remote events should not be reassessed.**

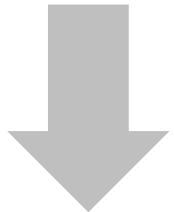
Overall Proposed Changes



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

Current EPS for Convertible Instruments

Effect of Conversion on EPS			
		Treasury Method	“If Converted” Method
Scope		Convertible debt with the principal settled in cash and premium settled in cash or shares (so called “Instrument C”)	<ul style="list-style-type: none"> All other convertible debt Convertible preferred shares
Diluted EPS	Numerator	No adjustment made	Add back interest and dividends
	Denominator	Adjust for additional shares calculated by the following formula: $\frac{(Average\ Share\ Price - Strike\ Price) * Conversion\ Ratio}{Average\ Share\ Price}$	Adjust for the additional shares issuable upon the assumed conversion as of the beginning of the year

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	
“If Converted” Method	
Scope	<ul style="list-style-type: none"> All convertible instruments
Diluted EPS	Numerator Add back interest and dividends. For convertible debt where the principal is required to be paid in cash, the interest shall not be added back to the numerator.
	Denominator Adjust for the additional shares issuable upon the assumed conversion as of the beginning of the year. Clarify that average share price should be used to calculate the potential dilution.

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?