

# Hot Topic: Convertible instruments

## How ASU 2020-06 will affect convertible debt that the issuer can settle in cash and/or shares

December 15, 2020



### Convertible debt instruments that can be settled in cash and/or shares (referred to as 'Instrument X') will be significantly impacted by ASU 2020-06.

#### Background and key impacts

In August 2020, the FASB issued ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity. The ASU's key impacts on convertible instruments include:

- The ASU changes the accounting for convertible instruments by reducing the number of accounting models. It requires convertible debt instruments to be accounted for under one of the following three models: embedded derivative, substantial premium, or no proceeds allocated (traditional debt) models. It eliminates the cash conversion and beneficial conversion feature models, which will likely result in more convertible debt instruments being accounted for as a single unit. This, in turn, will likely increase debt – and decrease equity – on an issuer's balance sheet and result in lower interest expense on an issuer's income statement.
- The ASU amends the requirements for a conversion option to be classified in equity, which will likely result in more conversion features meeting a scope exception from embedded derivative accounting.
- The ASU amends diluted earnings per share (EPS) calculations for certain convertible debt instruments, which will generally result in more dilutive EPS results.

Some convertible instruments include 'cash conversion' features, which allow the instrument's issuer to settle (or partially settle) a holder's exercise of the conversion option with cash instead of shares. The following table describes different types of convertible debt instruments, as described by the SEC staff<sup>1</sup>, that contain cash conversion features.

<sup>1</sup> [Remarks at the 2003 Thirty-First AICPA National Conference on Current SEC Developments](#)

Instrument type	Description of issuer's conversion option
<b>Instrument B</b>	Issuer is permitted to settle the entire obligation in either shares or cash in an amount equal to the conversion value.
<b>Instrument C</b>	Issuer is required to settle the principal amount (or accreted value) in cash and can elect to satisfy the conversion spread (the excess of conversion value over the principal amount) in either cash or shares.
<b>Instrument X</b>	Issuer is permitted to satisfy its obligation by delivering any combination of shares or cash equal to the conversion value.

Of these instruments, ASU 2020-06 is likely to have the most significant impact on the financial statements of an issuer of Instrument X.

- The amendments in ASU 2020-06 eliminate the existing accounting model for convertible instruments with cash conversion features, which requires separation of an equity component from the liability component.
- The amendments prohibit an issuer from rebutting the presumption that a conversion will be settled in shares in its diluted EPS computations; they allow the issuer to assume cash settlement only if it is more dilutive.

This Hot Topic uses an example to illustrate these effects on Instrument X. Additionally, this Hot Topic discusses certain effects on the presentation of contractually modifying an Instrument X to an Instrument C, as well as other transition guidance.

For additional information, see:

- KPMG Handbook, [Debt and equity financing](#)
- KPMG Handbook, [Earnings per share](#)
- KPMG Defining Issues, [FASB simplifies accounting for convertible instruments and contracts in an entity's own equity](#)

## Example: Effects of ASU 2020-06 on Instrument X

On January 1, Year 1 ABC Corp. issues a series of 1,000 fixed-rate bonds with a 20-year maturity. The bonds are issued for their aggregate par amount of \$1,000,000. They have a 4% stated coupon interest rate, and cash interest payments are made annually on December 31.

The holder has the option to convert each bond at any time to 20 of ABC's \$1 par value common shares (i.e. a conversion price of \$50 per share). On conversion, ABC can elect to settle by delivering a combination of cash and/or common shares with an aggregate value equal to the current market price of 20 of ABC's common shares (i.e. the conversion value); therefore, this is an Instrument X. ABC has a stated policy and past practice of settling the bond principal in cash instead of common shares. The bonds do not contain embedded features other than the conversion option.

The fair value (market price) per share of ABC common shares is summarized in the following table.

Date	
<b>Closing prices on the date</b>	
January 1, Year 1 (issuance date)	\$50
January 1, Year 5 (conversion date)	\$75
<b>Average price for the period</b>	
January 1, Year 4 – December 31, Year 4	\$64

ABC's net income before the effects of the convertible bonds is summarized in the following table.

Year ended	Amount
December 31, Year 4	\$5,031,600
December 31, Year 5	\$5,250,000

The tax basis of the bonds is \$1,000,000 and ABC is entitled to tax deductions based on cash interest payments. ABC does not receive a tax deduction for the payment of consideration upon conversion in excess of the tax basis of the convertible notes, regardless of the form of that consideration (cash or shares). ABC's income tax rate is 21%.

For simplicity, this example does not reflect debt issuance costs and presumes that ABC issues only annual financial statements.

## Post-ASU 2020-06 adoption

### Accounting model for convertible debt

ABC has not elected the fair value option. Therefore, the first step is to determine which accounting model will be used for the instrument.

This example assumes that the conversion option does not require bifurcation as an embedded derivative because it qualifies for the 'own equity' scope exception from derivative accounting in Subtopic 815-40. Because the debt was issued at its principal amount, it was not issued at a substantial premium. As a result, neither the embedded derivative nor substantial premium models apply, thereby requiring ABC to use the no proceeds allocated (traditional debt) model. Under this model, the debt is accounted for as a single unit.

### Year 1: Recognition and initial measurement

All proceeds are allocated to the convertible debt as a single unit (i.e. no proceeds are allocated to the conversion feature). ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash (received from issuance)	1,000,000	
Bonds payable		1,000,000
<i>To recognize issuance of convertible bonds.</i>		

## Comparison to legacy US GAAP

### Accounting model for convertible debt

Before adoption of ASU 2020-06, the convertible debt would be accounted for under the cash conversion model (assuming the conversion option was not bifurcated as an embedded derivative). This is because the conversion option provides for settlement in cash on conversion, including partial cash settlement. The cash conversion model was eliminated by ASU 2020-06.

### Year 1: Recognition and initial measurement

Before adoption of ASU 2020-06, the liability component under the cash conversion model would be recorded based on the fair value of a similar liability without a conversion option, with the remaining proceeds allocated to the equity component.

ABC would have recorded the following journal entries if – at issuance – the fair value of a similar liability that does not have a conversion option is \$600,000.

	<i>Debit</i>	<i>Credit</i>
Cash (received from issuance)	1,000,000	
Bonds payable – Discount	400,000	
APIC – Cash conversion option <sup>1</sup>		400,000
Bonds payable		1,000,000
<i>To recognize issuance of convertible bonds.</i>		

## Post-ASU 2020-06 adoption

### Years 1, 2 and 3: Subsequent measurement

Not illustrated

### Year 4: Subsequent measurement

ABC subsequently measures the bonds at their amortized cost. Because the convertible debt was issued at par, interest expense is recorded each period based on the debt's stated interest rate. At December 31, Year 4, ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	40,000	
Cash <sup>1</sup>		40,000
<i>To recognize interest expense on convertible bonds.</i>		
Current taxes payable <sup>2</sup>	8,400	
Current income tax benefit		8,400
<i>To recognize tax impact of interest payment on convertible bonds.</i>		

## Comparison to legacy US GAAP

	<i>Debit</i>	<i>Credit</i>
APIC <sup>2</sup>	84,000	
Deferred tax liability		84,000
<i>To recognize tax impact of convertible bonds issuance.</i>		
Notes:		
1. \$1,000,000 proceeds less the \$600,000 liability component.		
2. 21% of the \$400,000 equity component, which represents a temporary difference arising from the book-tax basis difference.		

### Years 1, 2 and 3: Subsequent measurement

Not illustrated

### Year 4: Subsequent measurement

Before adoption of ASU 2020-06, the discount on the liability component arising from allocating proceeds to equity for the cash conversion option would be accreted using the effective interest method in Topic 835. At December 31, Year 4, ABC would have recorded the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	50,900	
Cash <sup>1</sup>		40,000
Bonds payable – Discount <sup>2</sup>		10,900
<i>To recognize interest expense on convertible bonds.</i>		
Current taxes payable <sup>3</sup>	8,400	
Deferred tax liability <sup>4</sup>	2,300	
Current income tax benefit <sup>3</sup>		8,400
Deferred income tax benefit <sup>4</sup>		2,300
<i>To recognize tax impact of convertible bond transactions.</i>		

## Post-ASU 2020-06 adoption

### Notes:

1. \$1,000,000 par value × 4% stated coupon interest rate.
2. Represents the tax effect of deductions for cash interest payments: \$40,000 × 21%.

Including the effects of the convertible bonds, net income for the year ended December 31, Year 4 is as follows.

After-tax net income, other than the effects of the convertible bonds	\$5,031,600
<b>Effects of convertible bonds:</b>	
Interest expense	(40,000)
Income tax benefit	8,400
<b>Net income</b>	<b>\$5,000,000</b>

### Year 4: EPS calculations

ABC has the option to settle its convertible debt in shares or cash, and there is no required cash settlement feature. Under the provisions of ASU 2020-06, ABC must presume share settlement, if the effect is more dilutive, and use the if-converted method to calculate EPS.

The following additional information is relevant for purposes of EPS calculations.

- ABC has 1,000,000 common shares outstanding on January 1, Year 4 and throughout the year ended December 31, Year 4.
- The convertible debt is the only potential common share instrument outstanding.

## Comparison to legacy US GAAP

### Notes:

1. \$1,000,000 par value × 4% stated coupon interest rate.
2. Represents discount accretion under the effective interest method.
3. Represents the tax effect of deductions for cash interest payments: \$40,000 × 21%.
4. Represents partial reversal of the deferred tax liability due to accretion of the debt discount: \$10,900 × 21% (rounded).

Including the effects of the convertible bonds, net income for the year ended December 31, Year 4 before adoption of ASU 2020-06 would have been as follows.

After-tax net income, other than the effects of the convertible bonds	\$5,031,600
<b>Effects of convertible bonds:</b>	
Interest expense	(50,900)
Income tax benefit	10,700
<b>Net income</b>	<b>\$4,991,400</b>

### Year 4: EPS calculations

Before adoption of ASU 2020-06, ABC could have rebutted the presumption of share settlement for the principal amount if it:

- had a stated policy and past practice of settling the principal in cash instead of common shares; and
- could demonstrate the intent and ability to settle the principal amount in cash. (ABC would need to indicate how it would obtain the cash necessary for such settlement.)

If ABC had rebutted the share-settlement presumption, it would have used the treasury stock method for the conversion spread in calculating its diluted EPS. This is consistent with how EPS was calculated for an Instrument C (i.e. *required* the issuer to settle the principal amount in cash and permitted the issuer to

## Post-ASU 2020-06 adoption

Because ABC must presume share settlement if more dilutive, this example presents the impact of share settlement on the calculation of dilutive EPS. A separate calculation must be performed assuming cash settlement and considered in step three of the EPS calculation for potential dilution.

ABC calculates EPS as follows.

Step	Basic EPS
1	<b>Determine the numerator</b> No adjustment is necessary. The numerator is \$5,000,000.
2	<b>Determine the denominator</b> There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,000,000.
3	<b>Determine basic EPS</b> Basic EPS = $\$5,000,000 \div 1,000,000 = \$5.00$

Step	Diluted EPS
1	<b>Identify potential common shares</b> The convertible bonds are the only potential common shares.
2	<b>For each potential common share, calculate earnings per incremental share (EPIS)</b> For contracts that may be settled in common shares or cash at ABC's option, ABC determines whether cash or share settlement is more dilutive. Therefore, it calculates diluted EPS under both assumptions to determine which is more dilutive. <i>Share-settlement assumption</i> Under this assumption, the contract is settled in common shares, and the effect of cash settlement (i.e. liability classification) is reversed. <i>Potential adjustment to the numerator for EPIS:</i> The full conversion of the bonds would increase income for the year by the after-tax amount of the interest expense:

## Comparison to legacy US GAAP

settle the conversion spread in any combination of cash and/or shares).

Step	Basic EPS
1	<b>Determine the numerator</b> No adjustment is necessary. The numerator is \$4,991,400.
2	<b>Determine the denominator</b> There is no change in the number of outstanding shares during the year. Therefore, the denominator is 1,000,000.
3	<b>Determine basic EPS</b> Basic EPS = $\$4,991,400 \div 1,000,000 = \$4.99$

Step	Diluted EPS
1	<b>Identify potential common shares</b> The convertible bonds are the only potential common shares.
2	<b>For each potential common share, calculate earnings per incremental share (EPIS)</b> <i>Potential adjustment to the numerator for EPIS:</i> No adjustment is required because ABC's past practice and stated policy is that it settles the principal in cash, and ABC can demonstrate its intent and ability to do so. Therefore, the cash payment would be incurred regardless. <i>Potential adjustment to the denominator for EPIS:</i> The adjustment is determined using the treasury stock method to calculate the shares to be added for the conversion premium, as follows.

## Post-ASU 2020-06 adoption

Step	Diluted EPS
	<p><math>(\text{interest expense on the convertible bonds}) \times (1 - \text{income tax rate}) = (\\$40,000) \times (1 - 21\%) = \\$31,600.</math></p> <p>Potential adjustment to the denominator for EPIS: The full conversion of the bonds would increase the number of outstanding shares by 20,000.<sup>1</sup></p> <p>Note:</p> <p>1. 1,000 bonds issued <math>\times</math> 20 shares conversion ratio = 20,000 shares.</p>
<b>3</b>	<p><b>Rank the potential common shares</b></p> <p>This step does not apply, because the convertible bonds are the only class of potential common shares. As a result, there is no need to rank EPIS.</p>
<b>4</b>	<p><b>Determine basic EPS from continuing operations</b></p> <p>Basic EPS is \$5.00 (see Step 3 of basic EPS calculation).</p>
<b>5</b>	<p><b>Identify dilutive potential common shares and determine diluted EPS</b></p> <p>The potential effect of convertible bonds is determined as follows.</p>

## Comparison to legacy US GAAP

Step	Diluted EPS																								
	<table border="1"> <tbody> <tr> <td><i>Step i</i></td> <td>Number of shares to be issued on settlement of the convertible bonds</td> <td>20,000</td> <td>(A)</td> </tr> <tr> <td></td> <td>Exercise price (conversion spread)<sup>1</sup></td> <td>\$14</td> <td>(B)</td> </tr> <tr> <td></td> <td><b>Assumed proceeds (total value of conversion spread)</b></td> <td>\$280,000</td> <td>(C) = (A) <math>\times</math> (B)</td> </tr> <tr> <td><i>Step ii</i></td> <td>Average market price of common shares</td> <td>\$64</td> <td>(D)</td> </tr> <tr> <td></td> <td><b>Number of common shares deemed repurchased</b></td> <td><math>n/a^2</math></td> <td></td> </tr> <tr> <td><i>Step iii</i></td> <td><b>Potential maximum number of shares issued upon conversion</b></td> <td>4,375</td> <td>(C) <math>\div</math> (D)</td> </tr> </tbody> </table> <p>Notes:</p> <ol style="list-style-type: none"> <li>For purposes of EPS calculations, the conversion spread is determined based on the average share price for the period [\$64 average market price - \$50 conversion price].</li> <li>This application of the treasury stock method does not assume repurchase of shares, but shares are issued for the value of the conversion spread, as described in paragraph 260-10-55-84B.</li> </ol>	<i>Step i</i>	Number of shares to be issued on settlement of the convertible bonds	20,000	(A)		Exercise price (conversion spread) <sup>1</sup>	\$14	(B)		<b>Assumed proceeds (total value of conversion spread)</b>	\$280,000	(C) = (A) $\times$ (B)	<i>Step ii</i>	Average market price of common shares	\$64	(D)		<b>Number of common shares deemed repurchased</b>	$n/a^2$		<i>Step iii</i>	<b>Potential maximum number of shares issued upon conversion</b>	4,375	(C) $\div$ (D)
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<i>Step iii</i>	<b>Potential maximum number of shares issued upon conversion</b>	4,375	(C) $\div$ (D)																						
<b>3</b>	<p><b>Rank the potential common shares</b></p> <p>This step does not apply, because there is only one class of potential common shares. As a result, there is no need to rank EPIS.</p>																								
<b>4</b>	<p><b>Determine basic EPS from continuing operations</b></p> <p>Basic EPS is \$4.99 (see Step 3 of basic EPS calculation).</p>																								
<b>5</b>	<p><b>Identify dilutive potential common shares and determine diluted EPS</b></p> <p>The convertible bonds are dilutive because no adjustment to the numerator for EPIS is required.</p>																								



## Post-ASU 2020-06 adoption

Step	Diluted EPS			
	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	\$5,000,000	1,000,000	\$5.00	
Convertible bonds	31,600	20,000		
<b>Total</b>	<b>\$5,031,600</b>	<b>1,020,000</b>	\$4.93	✓

Therefore, ABC includes the effect of the convertible bonds in diluted EPS.

Note that because the cash settlement option resulted in no adjustments to the numerator and denominator, the cash settlement option equals basic EPS. As a result, the share settlement option is more dilutive than the cash settlement option.

**Diluted EPS = \$4.93**

## Comparison to legacy US GAAP

Step	Diluted EPS			
	Earnings	Weighted-avg. no. of shares	Per share	Dilutive?
Basic EPS	\$4,991,400	1,000,000	\$4.99	
Convertible bonds	-	4,375		
<b>Total</b>	<b>\$4,991,400</b>	<b>1,004,375</b>	<b>\$4.97</b>	✓

Therefore, ABC includes the effect of the convertible bonds in diluted EPS.

Note that had ABC not rebutted the share settlement presumption, it would have calculated diluted EPS under both assumptions to determine which is more dilutive. Because the cash settlement option resulted in no adjustments to the numerator and denominator, the cash settlement option equals basic EPS. As a result, the share settlement option is more dilutive than the cash settlement option.

**Diluted EPS = \$4.97**

### KPMG observation: If-converted method for Instruments C and X

Under ASU 2020-06, an entity is required to include all convertible instruments in diluted EPS using the if-converted method.

- **Instrument C:** When an instrument *contractually requires* the principal to be settled in cash, the numerator is not adjusted for interest because the interest would always be paid. Therefore, the if-converted method will produce similar results to the treasury stock method that was used for Instrument C before the adoption of ASU 2020-06, as both methods include only denominator adjustments for this instrument.
- **Instrument X:** Prior to the adoption of ASU 2020-06, if the issuer could rebut the share settlement presumption, Instrument X could be reflected in EPS similar to Instrument C. This is because for both instruments the principal is (presumed to be) repaid in cash. However, as reflected in the EPS calculation above, after adopting ASU 2020-06 an entity may no longer rebut the share settlement presumption for Instrument X and present EPS assuming cash settlement only if it is more dilutive. That is, *an Instrument X may no longer be treated as an Instrument C for EPS purposes, unless cash settlement results in a more dilutive EPS than share settlement.* Instrument X is included in diluted EPS using the if-converted method *with* a numerator adjustment for the interest expense associated with the convertible debt instrument recorded during the period. This results in a difference between the EPS effects of Instrument C and Instrument X after adoption of ASU 2020-06.

## Post-ASU 2020-06 adoption

### Year 5: Conversion of the convertible debt instrument

On January 1, Year 5, the conversion option is exercised by all holders of the convertible bonds. At that date, the if-converted value of the bonds is \$1,500,000 (each bond is convertible into 20 shares × 1,000 bonds × \$75 actual market value at conversion). ABC settles the if-converted value by paying \$1,000,000 cash for the principal amount and issuing common shares for the \$500,000 conversion premium.

At the conversion date, ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Bonds payable	1,000,000	
APIC	6,666	
Cash		1,000,000
Common shares (par value) <sup>1</sup>		6,666
<i>To record conversion of bonds.</i>		
Note:		
1. \$500,000 conversion spread ÷ \$75 stock price per share = 6,666 shares issued × \$1 par value = \$6,666.		

## Comparison to legacy US GAAP

### Year 5: Conversion of the convertible debt instrument

Before adoption of ASU 2020-06, the convertible debt described in this example would be accounted for under the cash conversion model. Under the derecognition guidance for that model (other than for induced conversions), when a convertible debt instrument is derecognized, the consideration transferred to the holder is first allocated to the extinguishment of the liability component up to its fair value, with the remaining consideration allocated to the reacquisition of the equity component.

On January 1, Year 5, the bonds would have an accreted value of \$639,000 (\$600,000 initial carrying amount plus four years of discount accretion under the effective interest method totaling \$39,000, rounded).

The fair value of the liability component is \$700,000 on the conversion date.

ABC would have recorded the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Bonds payable	1,000,000	
APIC – Cash conversion option <sup>1</sup>	800,000	
Loss on extinguishment <sup>2</sup>	61,000	
Deferred tax liability <sup>3</sup>	75,810	
Bonds payable – Discount <sup>4</sup>		361,000
Cash		1,000,000
Common stock at par		6,666
APIC – share issuance <sup>5</sup>		493,334
Deferred income tax benefit <sup>6</sup>		12,810
APIC <sup>7</sup>		63,000
<i>To recognize payoff of notes.</i>		

## Post-ASU 2020-06 adoption

Including the effects of the convertible bonds, net income for the year ended December 31, Year 5 is as follows.

Net income, other than the effects of the convertible bonds	\$5,250,000
<b>Effects of convertible bonds:</b>	
N/A	
<b>Net income</b>	<b>\$5,250,000</b>

### Year 5: EPS calculations

ABC had 1,000,000 weighted-average common shares outstanding on January 1, Year 5 and issued an additional 6,666 on that date to settle the conversion. No other shares were issued during the year.

## Comparison to legacy US GAAP

Notes:

1. ABC issued \$1,500,000 consideration to settle the bonds. \$700,000 is attributed to the fair value of the liability component. The remainder (\$800,000) is attributed to the reacquisition of the equity component.
2. The net carrying amount of the notes on the date of derecognition is \$639,000. Because the fair value of the liability component exceeds the net carrying amount, a loss on extinguishment of \$61,000 [\$700,000 – \$639,000] is recorded for the difference.
3. Represents the writeoff of the remaining deferred tax liability that was established on the date the notes were issued related to the discount: \$84,000 initial amount – \$8,190 benefit recorded on accretion of the discount.
4. Represents the writeoff of the unaccreted discount: \$400,000 – \$39,000 accretion.
5. Represents the effect on APIC of the share issuance: \$500,000 conversion spread – 6,666 par value of shares issued.
6. 21% of the loss on extinguishment recognized of \$61,000 (see Note 2).
7. Represents the effect on APIC of the deferred tax entries: \$75,810 in Note 3 – \$12,810 in Note 6.

Including the effects of the convertible bonds, net income for the year ended December 31, Year 5 is as follows.

Net income, other than the effects of the convertible bonds	\$5,250,000
<b>Effects of convertible bonds:</b>	
Loss on extinguishment	(61,000)
Income tax benefit	12,810
<b>Net income</b>	<b>\$5,201,810</b>

### Year 5: EPS calculations

ABC had 1,000,000 weighted-average common shares outstanding on January 1, Year 5 and issued an additional 6,666 on that date to settle the conversion. No other shares were issued during the year.

## Post-ASU 2020-06 adoption

The convertible bonds have no effect on diluted EPS as compared to basic EPS for Year 5 because the debt was converted on the first day of the fiscal year.

Step	Basic EPS																								
<b>1</b>	<p><b>Determine the numerator</b></p> <p>No adjustment is necessary. The numerator is \$5,250,000.</p>																								
<b>2</b>	<p><b>Determine the denominator</b></p> <p>There is no change in the number of outstanding shares during the year, other than the shares issued in settlement of the conversion option. Therefore, the denominator is 1,006,666.</p> <table border="1"> <thead> <tr> <th></th> <th>Number of shares</th> <th>Time weight</th> <th>Weighted average</th> </tr> </thead> <tbody> <tr> <td><b>Jan 1</b></td> <td>1,000,000</td> <td>0/12</td> <td></td> </tr> <tr> <td>Jan 1: shares issued for conversion of debt</td> <td>6,666</td> <td></td> <td></td> </tr> <tr> <td><b>Jan – Dec</b></td> <td>1,006,666</td> <td>12/12</td> <td>1,006,666</td> </tr> <tr> <td></td> <td></td> <td>12/12</td> <td></td> </tr> <tr> <td><b>Weighted average for the year</b></td> <td></td> <td></td> <td><b>1,006,666</b></td> </tr> </tbody> </table>		Number of shares	Time weight	Weighted average	<b>Jan 1</b>	1,000,000	0/12		Jan 1: shares issued for conversion of debt	6,666			<b>Jan – Dec</b>	1,006,666	12/12	1,006,666			12/12		<b>Weighted average for the year</b>			<b>1,006,666</b>
	Number of shares	Time weight	Weighted average																						
<b>Jan 1</b>	1,000,000	0/12																							
Jan 1: shares issued for conversion of debt	6,666																								
<b>Jan – Dec</b>	1,006,666	12/12	1,006,666																						
		12/12																							
<b>Weighted average for the year</b>			<b>1,006,666</b>																						
<b>3</b>	<p><b>Determine basic EPS</b></p> <p>Basic EPS = <math>\\$5,250,000 \div 1,006,666 = \\$5.22</math></p> <p>Note that diluted EPS is the same as basic EPS in Year 5 because there are no remaining potential common shares.</p>																								

## Comparison to legacy US GAAP

The convertible bonds have no effect on diluted EPS as compared to basic EPS for Year 5 because the debt was converted on the first day of the fiscal year. However, basic EPS would be different because net income is different pre-adoption of ASU 2020-06.

Step	Basic EPS																								
<b>1</b>	<p><b>Determine the numerator</b></p> <p>No adjustment is necessary. The numerator is \$5,201,810.</p>																								
<b>2</b>	<p><b>Determine the denominator</b></p> <p>There is no change in the number of outstanding shares during the year, other than the shares issued in settlement of the conversion option. Therefore, the denominator is 1,006,666.</p> <table border="1"> <thead> <tr> <th></th> <th>Number of shares</th> <th>Time weight</th> <th>Weighted average</th> </tr> </thead> <tbody> <tr> <td><b>Jan 1</b></td> <td>1,000,000</td> <td>0/12</td> <td></td> </tr> <tr> <td>Jan 1: shares issued for conversion of debt</td> <td>6,666</td> <td></td> <td></td> </tr> <tr> <td><b>Jan – Dec</b></td> <td>1,006,666</td> <td>12/12</td> <td>1,006,666</td> </tr> <tr> <td></td> <td></td> <td>12/12</td> <td></td> </tr> <tr> <td><b>Weighted average for the year</b></td> <td></td> <td></td> <td><b>1,006,666</b></td> </tr> </tbody> </table>		Number of shares	Time weight	Weighted average	<b>Jan 1</b>	1,000,000	0/12		Jan 1: shares issued for conversion of debt	6,666			<b>Jan – Dec</b>	1,006,666	12/12	1,006,666			12/12		<b>Weighted average for the year</b>			<b>1,006,666</b>
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<b>Weighted average for the year</b>			<b>1,006,666</b>																						
<b>3</b>	<p><b>Determine basic EPS</b></p> <p>Basic EPS = <math>\\$5,201,810 \div 1,006,666 = \\$5.17</math></p> <p>Note that diluted EPS is the same as basic EPS in Year 5 because there are no remaining potential common shares.</p>																								

## Summary comparison of financial statement effects: Years 4 and 5

At the end of each period, ABC's financial statements reflect the following related to the convertible debt.

Account	Post-ASU 2020-06 adoption		Before ASU 2020-06 adoption	
	Dec 31, Year 4	Dec 31, Year 5	Dec 31, Year 4	Dec 31, Year 5
<b>Balance sheet – liabilities</b>				
Convertible debt	\$ 1,000,000	\$ -	\$ 639,000	\$ -
<b>Balance sheet – equity</b>				
Common shares	\$ -	\$ 6,666	\$ -	\$ 6,666
APIC	\$ -	\$ (6,666)	\$ 400,000	\$ 156,334 <sup>2</sup>
<b>Income statement</b>				
Interest expense	\$ 40,000	\$ -	\$ 50,900	\$ -
Loss on extinguishment of convertible debt	N/A	\$ -	N/A	\$ 61,000
Net income <sup>1</sup>	\$ 5,000,000	\$ 5,250,000	\$ 4,991,400	\$ 5,201,810
<b>Weighted-average shares (EPS calculations)</b>				
Basic	1,000,000	1,006,666	1,000,000	1,006,666
Diluted	1,020,000	1,006,666	1,004,375	1,006,666
<b>Earnings per share</b>				
Basic	\$ 5.00	\$ 5.22	\$ 4.99	\$ 5.17
Diluted	\$ 4.93	\$ 5.22	\$ 4.97	\$ 5.17

Notes:

1. Includes the income tax effects of convertible debt transactions.
2. \$400,000 recorded upon issuance - \$800,000 deemed repurchase of the equity component + \$493,334 share issuance upon conversion + \$63,000 deferred tax impact



## Effective date and transition

	Public business entities that are SEC filers and are not eligible to be a smaller reporting company	All other entities
Annual periods in fiscal years beginning after:	December 15, 2021	December 15, 2023
Interim periods in fiscal years beginning after:	December 15, 2021	December 15, 2023
Early adoption allowed?	<p>Yes, no earlier than annual and interim periods in fiscal years beginning after December 15, 2020.</p> <p>An entity that has not yet adopted the amendments to the guidance for accounting for certain instruments with down-round features in ASU 2017-11 may adopt the recognition and measurement amendments in ASU 2020-06 for any convertible security that includes a down-round feature (see <a href="#">Defining Issues</a>) in financial statements that have not yet been issued or made available for issuance for fiscal years (or interim periods) beginning after December 15, 2019.</p>	

### KPMG observation: Date of adoption

The standard states that early adoption is allowed for annual and interim periods in fiscal years beginning after December 15, 2020. However, an entity should adopt the guidance at the beginning (i.e. during the first quarter and as of the first day) of its fiscal year. For example, if a calendar-year public business entity is an SEC filer and is not eligible to be a smaller reporting company, it can early adopt the standard only on January 1, 2021, otherwise, it must adopt the standard on January 1, 2022.

When adopting ASU 2020-06, an entity may select either a modified or full retrospective transition method and may irrevocably elect the fair value option for any liability-classified convertible financial instrument that is eligible under Subtopic 825-10.

#### Modified retrospective method

- Cumulative-effect adjustment to the opening balance of retained earnings at the date of adoption
- EPS in prior periods is not restated

#### Full retrospective method

- Cumulative-effect adjustment to the opening balance of retained earnings in the earliest period presented

## KPMG observation: Presentation of modified convertible debt instruments

Certain instruments that permit the issuer to settle a conversion in any combination of cash and/or shares give the issuer the ability to unilaterally modify the instrument's terms to require cash settlement of the principal amount (i.e. an Instrument X's contractual terms may permit the issuer to unilaterally revise it to an Instrument C). We understand that some issuers may wish to unilaterally exercise this existing option in contemplation of ASU 2020-06 adoption. Further, we understand that some issuers of Instrument X without that feature may wish to modify (through agreement with the debt holders) the contractual terms to require cash settlement of the principal amount.

### Earnings per share presentation

We believe the impact of adoption should be based on the contractual terms in effect at adoption. For example, ABC previously issued an Instrument X that is convertible by the holder at any time and matures in 2025. On December 31, 2020, the contractual terms of the convertible debt are modified to require ABC to cash settle the principal amount upon conversion (i.e. it is contractually modified to be an Instrument C). ABC is a calendar-year entity that is adopting ASU 2020-06 as of January 1, 2021 (i.e. through early adoption). Presentation of the instrument includes the following EPS considerations, depending on the transition method selected:

- **Modified retrospective method:** The contractual terms in effect as of January 1, 2021 are used. ABC reflects the convertible debt in its EPS calculations as an Instrument C as of the adoption date and for reporting dates thereafter. If ABC rebutted the share settlement presumption in EPS calculations before adopting ASU 2020-06, the convertible debt would be reflected in EPS calculations similarly to an Instrument C in the comparative earlier periods.
- **Full retrospective method:** The contractual terms in effect at the beginning of the earliest period presented are used for periods before December 31, 2020, with the effects of the modification reflected starting at the date of the modification. Because the convertible debt was an Instrument X before December 31, 2020, it is included in EPS calculations before that date with share settlement of the entire if-converted value presumed if that is more dilutive. The convertible debt is only reflected as an Instrument C after the modification date.

### Balance sheet presentation – debt classification

An issuer presents a convertible debt instrument with a cash conversion feature as a short-term obligation if the instrument meets one of the following conditions (unless the issuer has the ability and intent to refinance the obligation on a long term basis; see section 3.6.20 of KPMG Handbook, [Debt and equity financing](#) for guidance on whether an entity has that ability and intent):

- permits the holder to demand repayment of the instrument (holder put option) within one year of the reporting date;
- has a maturity date within one year of the reporting date; or
- permits the holder to convert the instrument at the balance sheet date and the issuer must provide the holder with cash for the principal amount per the terms of the instrument.

Because the issuer of an Instrument X is not contractually obligated to settle a conversion feature in cash, it is not required to present any portion of the obligation as current. However, if an Instrument X is contractually modified to be an Instrument C, the principal amount (before adoption of ASU 2020-06, the liability component) is classified as current if any of the three conditions are met.



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